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Economic report on Africa 2004: unlocking Africa's potential in the global economy

Overview

Setting the scene for the successful integration of Africa into the global economy

After 50 years of very significant progress, the future of the multilateral system of trade negotiations is currently surrounded by great uncertainty. The collapse of the fifth Ministerial Conference of the World Trade Organization in Cancún, Mexico, in 2003 has put pressure on the countries of the Organization for Economic Cooperation and Development (OECD) to reduce agricultural subsidies and other domestic support measures that distort global trade and contribute to the marginalization of Africa from the international trading system.

The present report takes the view that OECD trade policies represent a serious constraint to Africa's integration in the global economy. African exports have been handicapped by industrial country policies such as tariff escalation, tariff peaks and agricultural protectionism. At the same time, the report argues that serious improvement is required in internal conditions, in particular on the supply-side, if Africa is to improve its position in the international economy. Weak infrastructure, poor trade facilitation services and the lack of physical and human capital pose a major impediment to export sector development. The report thus takes an introspective look at what Africa needs to do to put its house in order so as to benefit from existing and future opportunities in the global trading system and addresses fundamental issues regarding pending reforms for African policy makers.

If progress is to be made, Africa needs to make a concerted effort to reform its own economies through diversification of its productive structure and the adoption of more proactive policies for the integration of the continent into the global economy. With these objectives in mind, the Economic Report on Africa 2004 is a contribution to the debate on how to strengthen the continent's economic performance in areas such as energy policy, trade facilitation and competitiveness.

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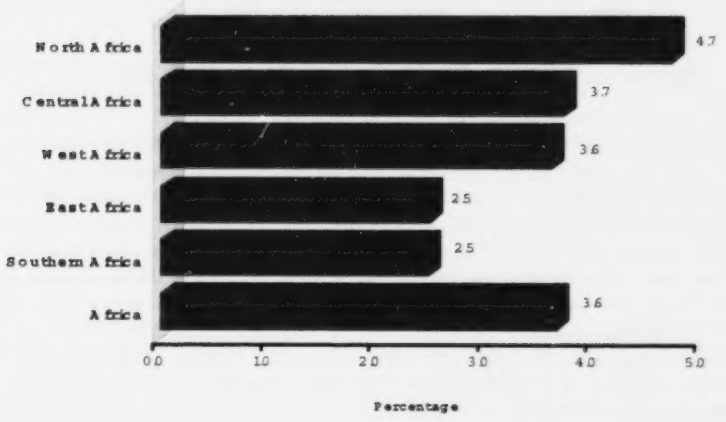
I. Economic performance: improving, but still insufficient

1. Despite insufficient progress towards fulfilling the Millennium Development Goals, and the persistence of serious political, social and economic problems in Africa, the overall message emanating from the report is an optimistic one. Contrary to popular impressions, in recent years, since the lost decades of the 1980s and 1990s, the continent has been making progress. In 2003, Africa was the second fastest growing region in the developing world, behind Eastern and Southern Asia. Higher oil prices and production, rising commodity prices, increased foreign direct investments and good macroeconomic fundamentals, backed up by good weather conditions underpinned this high growth. As a result, growth in real gross domestic product (GDP) was 3.6 per cent in 2003, compared to 3.2 per cent in 2002, with North Africa putting in a particularly strong performance (of 4.7 per cent). West and Central Africa also exhibited respectable growth rates above 3.5 per cent. East and Southern Africa, in contrast, registered paltry growth of 2.5 per cent (see figure 1).

Figure 1
North Africa tops subregional economic performance in 2003

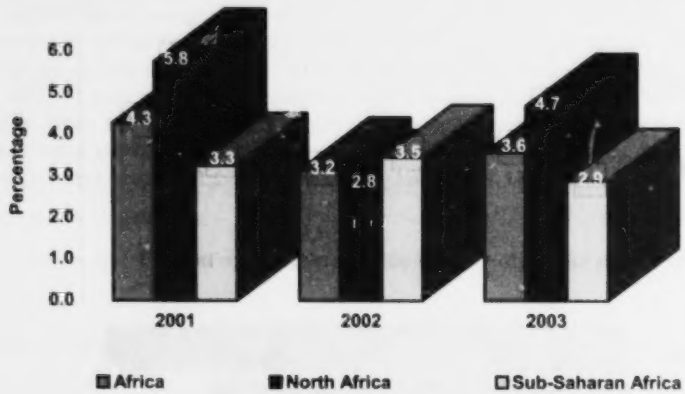


2. In 2003, the African continent, in aggregate, continued to exhibit good macroeconomic fundamentals. Fiscal deficits have largely been kept under control, despite the challenge faced by many countries in balancing increased spending on poverty reduction, as set out under their poverty reduction strategy papers and to preserve macroeconomic stability. Inflation rose slightly, to 10.6 per cent, compared to 9.3 per cent in 2002, reflecting higher food prices caused by poor weather conditions in some parts of Africa, higher oil-import prices and currency depreciation in several countries. The regional current account deficit fell from 1.6 per cent of GDP in 2002 to 0.7 per cent of GDP in 2003, driven by robust oil and commodity prices and high worker remittances.

3. On the downside, there has been a significant increase in the dispersion of growth rates, with seven African economies experiencing negative growth rates; in 1999 not one country registered a negative growth rate, and only one in 2000. Moreover, when compared with the growth figures for 2001 and 2002, it becomes

clear that there has been a slight deterioration in aggregate economic performance for Sub-Saharan Africa, down from 3.5 per cent in 2002 to only 2.9 per cent in 2003 (see figure 2).

Figure 2
Rates of economic growth, North and Sub-Saharan Africa, 2001-2003



4. It should also be borne in mind that these are not per capita figures. Standing currently at 2 per cent and 2.2 per cent respectively, both North and Sub-Saharan Africa currently display the highest rates of demographic expansion in the world, more than double the world average of 1.2 per cent. Thus the real per capita growth rates for North Africa and Sub-Saharan Africa in 2003, at approximately 2.7 per cent and 1.7 per cent, respectively, are clearly inadequate to achieve the Millennium Development Goals for poverty reduction. The recent establishment of a new Commission for Africa, launched by British Prime Minister Tony Blair, in March 2004, represents an explicit and important acknowledgement of the need to address the problem of Africa's underperformance. As the Executive Secretary of the Economic Commission for Africa, K. Y. Amoako, recently commented:

> "The international community and Africa have agreed on the central importance of a partnership to achieve the goals of the New Partnership for Africa's Development, but we must now focus on implementation and action; we must agree on what we can really deliver for Africa's people."

II. The continent awaits the "Peace Dividend"

5. One of the principal reasons behind the poor economic performance of African countries has been military conflicts. For example, the political crisis in Côte d'Ivoire has had a significant impact on the social and economic conditions of the neighbouring countries Mali and Burkina Faso. In the early 1990s, in the aftermath of the Cold War, many political analysts were predicting a significant "peace dividend", in reference to the resolution of many historic conflicts that had blighted the region, and the expected "dividend", a subsequent economic, political and social recovery. As

we now know, that "peace dividend" never materialized: the 1990s were the most conflict-ridden years since independence, and economic performance was lacklustre. African policy makers are keenly aware of the fact that substantial improvements in the economic and social situation of their populations are totally contingent upon the maintenance of peace. Without peace, little or nothing can be achieved.

6. In 2003, there were significant improvements in several politically unstable countries. The Government of the Sudan and its main rebel opposition took a crucial step towards a formal peace pact that would end Africa's longest running civil war. Liberia pushed its ex-president, Charles Taylor, into exile and there is hope that the civil wars in neighbouring countries will abate. In November 2003, the Government of Burundi signed a peace agreement with the main rebel group to end the country's civil war and took steps to integrate former rebels into the democratic political process. Uganda and Rwanda withdrew from the Democratic Republic of the Congo, setting the stage for reconciliation. Peaceful political transitions in Angola and the Democratic Republic of the Congo are paying off. Angola attracted substantial foreign direct investment during the year, with more to come in 2004, and GDP grew at over 12 per cent. The Democratic Republic of the Congo, on a steady path to macroeconomic stability with a single digit inflation in 2003, has made remarkable progress given the inflation rate of over 500 per cent as recently as 2000; economic growth is currently standing at over 5 per cent.

7. The continuing political instability in Zimbabwe and Côte d'Ivoire is worrisome. In Zimbabwe, political volatility has weakened macroeconomic stability, with inflation rising to 420 per cent in 2003, the fiscal deficit deteriorating to 7.1 per cent of GDP and the economy shrinking for the fifth consecutive year. In West Africa, because of its position as an important regional transport hub, the crisis in Côte d'Ivoire has resulted in sharp slowdowns in the economies of Burkina Faso and Mali. In East Africa, the persistence of low intensity conflicts (for example, those in Uganda and the Sudan) has handicapped progress in the social, economic and political fields.

8. Recent empirical research has shown that political instability is adversely affecting human development as well as GDP and export growth in Africa.[1] Clearly, until all the political actors implicated (politicians, civil society, foreign governments, international organizations) make a concerted effort to resolve these conflicts, Africa is unlikely to see a substantial improvement in its economic or human development.

III. Insufficient and inconsistent external support hinders progress

9. Central to the New Partnership for Africa's Development is the idea that, concurrent with the application of appropriate domestic reforms, Africa needs substantial external support to make its renaissance viable. At the International Conference on Financing Development in Monterrey, Mexico, in 2002, the industrialized countries made a strong pledge to increase the quantity and quality of official development assistance (ODA) flows to Africa. However, at $19.4 billion in 2001, ODA flows are still significantly below the 1990 peak value. It is estimated that there is a shortfall of between $20 to 25 billion annually in the amount of ODA required for African countries to attain the Millennium Development Goals.

10. In this regard, there are a number of underlying inconsistencies in the donor discourse. For instance, despite official acknowledgement of its central role in any development strategy, gender equality receives relatively little support, with only $81 million in ODA applied to gender-related projects for the whole of Africa. Similarly, although there has been a welcome increase in ODA directed towards tackling the AIDS pandemic, minimal support has been provided for the fight against malaria, still one of the biggest killers in Sub-Saharan Africa.

11. Tied aid is another major concern. Tied aid (that is, the requirement to purchase exports from the donor country in return for ODA) reduces the value of aid to the recipient countries by 25 to 40 per cent, by obliging them to purchase uncompetitively priced imports. Admittedly, some donors have made significant progress. The United Kingdom, Norway, Denmark and the Netherlands, for example, provided more than 90 per cent in untied aid in 2001. But some other countries continue to insist that a high percentage of aid be used to purchase exports from their own producers. This brings to the forefront an important issue, central to the present report — that it is not so much the volume of trade that is important, but rather its qualitative aspects that make a demonstrable difference from a developmental point of view.

IV. Continued difficulties on the road towards the liberalization of agriculture in the North

12. In recent years there have been a number of initiatives to improve market access for the poorest developing countries. The European Union "Everything but Arms" agreement, and the United States "African Growth and Opportunity Act" are two notable examples (see box 1 below). Preliminary evaluations of these two initiatives show modest but important gains for some sub-Saharan countries. In this sense, both initiatives set encouraging precedents for the future liberalization of industrial and agricultural markets in the countries of the Organization for Economic Cooperation and Development (OECD). However, because neither initiative involves the dismantling of damaging agricultural subsidies, they stop short of fulfilling Africa's needs if the continent's export potential is to be realized. For instance, in 2001, due to subsidies to domestic producers in the United States and the European Union, the costs of lower cotton prices to a country like Mali have been estimated at $43 million. Coincidentally, according to Oxfam, that was exactly the amount of debt relief received by Mali from the World Bank and IMF in the same year under the enhanced highly-indebted poor country initiative.

Box 1

The impact of the African Growth and Opportunity Act: some encouraging results but more needs to be done

The African Growth and Opportunity Act was signed into law on 18 May 2000. According to the web site (www.agoa.gov), "the Act offers tangible incentives for African countries to continue their efforts to open their economies and build free markets". However, because most African countries already enjoy preferential treatment owing to their status as least developed countries, for most products the preferences offered to African countries do not represent a significant improvement over the

existing GSP agreements. There are exceptions to this, of course, and for some products, such as textiles and apparel, where tariffs and quotas are higher, there are significant advantages in belonging to the scheme.

Circumstantial evidence certainly suggests that some African countries have benefited from the access agreement. For instance, under the act, South African exports to the United States of America were 45 per cent higher in 2002 than in the preceding year.[2] Nigeria, too, has been a big winner in its trading relations with the United States, accounting for more than 60 per cent of all exports under the act to the United States of America (although the bulk of this trade is related to the oil industry). There is also evidence to suggest that beneficiary countries have seen an increase in export-oriented foreign direct investment (FDI) linked to the act. For example, companies from Taiwan, Province of China, are the main investors in Lesotho's garment industry.

Nonetheless, according to the United States Department of Commerce, all this must be set against the backdrop of a 15 per cent fall in total United States imports from Sub-Saharan Africa in 2002. In fact, systematic research leads to a more sombre conclusion about the impact of the African Growth and Opportunity Act. In the first place, the benefits are limited because only "non-sensitive" products are included in the agreement. Secondly, excessively tight rules of origin and the limited list of countries admitted to benefits from the special textile preferences regime reduces the usefulness of the scheme for African textile producers. Thirdly, the regime expires in 2008, something which obviously tempers the reaction of potential investors. Finally, there is concern that the benefits of the act will be diluted as the United States Government seeks to negotiate free trade agreements with other regions such as the Middle East and Central America.

To improve the developmental and trade impact of the African Growth and Opportunity Act, it would be a positive development if the United States administration accepted some of the recommendations of the its Commission on Capital Flows, including an extension of the benefits of the act until 2018, and extended the preferences to include all products coming from Africa.

Source: Aaditiya Mattoo, Devesh Roy and Arvind Subramanian, "The African Growth and Opportunity Act and Its Rules of Origin: Generosity Undermined", World Bank, Policy Research Paper No. 2908, October 2002. UNCTAD, *Trade Preferences for LDCs: An Early Assessment of the Benefits and Possible Improvements*, New York and Geneva, 2003, and *The Least Developed Countries Report, 2002: Escaping the Poverty Trap*, New York and Geneva, 2002. United States Department of Commerce (2003) and United States Commission on Capital Flows to Africa (2003).

13. A forthcoming study by the Economic Commission for Africa in the implications of the Doha Agenda for Africa reveals the extent of the gains that might be realized by African countries if full liberalization of OECD agriculture is achieved. Using a global trade policy analysis model, a multisector, multiregional model widely used by trade analysts to examine the impact of trade policies, the study analyses three

different trade reform scenarios, capturing different degrees ("little", "modest" and "full") of trade liberalization. In the static version of the model, the study finds that full liberalization of trade would increase global welfare (income) by 0.3 per cent, but would add 0.7 per cent annually to income in the African region. Absolute gains for Sub-Saharan Africa are quite modest, however, some $704 million, when compared, for example, with the $15.86 billion gains for the 15 pre-accession member States of the European Union. The study also suggests that the gains from liberalization grow with the depth of the reforms. While North Africa benefits from all liberalization scenarios, Sub-Saharan and Southern Africa incur losses when partial liberalization is carried out. This is largely due to the impact of preference erosion, with many African countries being major beneficiaries of existing preferential trading arrangements. Partial market access reforms (the "modest" scenario) would thus increase the degree of competition they face in export markets.

14. However, when the model is modified to allow for dynamic effects, the study finds that there is a substantial increase in the benefits of trade reforms to all regions of the world. For the Sub-Saharan region, the welfare gains from full liberalization would increase from $704 million in the static model to $4.3 billion in the dynamic model. That is, the gain to Sub-Saharan Africa in the dynamic model is about six times as large as in the static model. The huge welfare gain from the dynamic model is associated with the impact of capital accumulation, a result that emphasizes the importance of complementing trade liberalization with investment enhancing policies.

15. There is potential downside of further agricultural liberalization. The findings of the simulation exercise suggest that the reforms may force countries to specialize more in the production of agricultural commodities, Resulting in the contraction of industrial activities in the region and the shift of resources into the production of commodities such as grains, sugar and cotton. Although this change in the pattern of specialization is dictated by comparative advantage, it is worrisome because excessive dependence on commodities increases the degree of vulnerability faced by the region. These findings drives home the urgency of adopting policies to promote export diversification out of primary commodities and into industrial and service industries with a higher value-added.

V. Primary commodity production: the need to diversify

16. In the past, a number of reports of the Economic Commission for Africa have analysed how Africa's heavy dependence on primary commodities as a source of export earnings has meant that the continent remains vulnerable to market vagaries and weather conditions. Price volatility, arising mainly from supply shocks, the decline in real commodity prices and attendant terms-of-trade losses have exacted heavy costs in terms of incomes, indebtedness, investment, poverty and development.[3] According to one World Bank study, in the case of African countries that are not oil exporters, the cumulative terms of trade losses in 1970-1997 represented almost 120 per cent of GDP, a massive and persistent drain of purchasing power. According to the same study, losses of that magnitude almost completely wiped out the benefits from the substantial increase in aid provided to the continent after 1973.[4] Nor has the story been much more encouraging for oil producing countries like Nigeria, Gabon or Angola: despite benefiting from massive terms of trade gains, the income derived from oil exports has not been used to

finance the necessary structural diversification of the economy and to place them on a sustainable growth part.

17. The logical policy advice stemming from this situation, both for oil-producing and oil importing countries, is that African countries need to diversify their economies away from agricultural and other primary products into sectors with a higher value-added. This suggests some kind of coherent strategy to promote diversification, in others words, an industrial policy. Some form of industrial policy is also required because of the apparent deadlock regarding negotiations within the World Trade Organization. Not only do the OECD countries seem reluctant to reduce the export subsidies for their own agricultural products, the dismantling of domestic farm support measures is currently politically untenable for most of the northern countries. The aforementioned conflict between West African countries and the United States over cotton subsidies is illustrative of the unwillingness of the OECD countries to reduce their subsidies.

18. A concerted effort towards trade diversification is therefore all the more urgent. Regrettably, since the period of structural adjustment, and against a backdrop of considerable pessimism in Africa concerning the capacity for State intervention, industrial policy has become an extremely controversial policy tool. Over the last two decades, many African countries have abandoned attempts to provide financial and technical support for domestic industry. Yet providing such support need not be so controversial:

(a) There is a strong theoretical and empirical case for selective interventions to overcome the market and institutional failures in building the capabilities required for industrial development;

(b) Many defenders of the free market and critics of industrial policy believe that the State is not capable of "picking winners". While this has, admittedly, often been true in the past, there could still be a strong justification for a more generalized industrial policy targeted at certain kinds of activities (e.g. investment, research and development, training, and so forth) rather than selective interventions to support particular industries or firms. This is indeed the path that industrialized countries like the United States have taken, with a plethora of measures to support national research and development programmes, infrastructural projects and a complicated system of tax breaks, and other incentives;

(c) Different ministries have different responsibilities regarding the needs for producing effective policies to increase the competitiveness of African economies. Coherent policies are required across ministries, including trade, employment, education, agriculture and transport.

19. Clearly, however modest the initial reforms and programmes, policies of this nature would take time to implement. For this reason, the principle of special and differential treatment continues to be of enormous importance for African countries. The industrialized countries need to be aware of the need for a generous time frame for liberalization if African economies are to be able to strengthen supply-side capacities and compete adequately in global markets.

VI. Lessons from Asia: the overriding need for industrial policy to promote export diversification

20. In Asia, where dynamic trade policies have been implemented, the experience is instructive. Using a complex combination of liberalization and control (sometimes excessive control) of the relations between the domestic economy and the outside world, Asian economies displayed robust growth. Against this backdrop, it is evident that African countries urgently need to address the problem of the lack of coherent and concerted industrial policies.

21. Early explanations of the Asian "miracle" focused on the apparent openness of the Asian economies to external markets, in contrast with the failed import substitution approach pursued in Africa. The root of Asia's success was thought to lie in State neutrality towards the economic sector, whereby the State stood by, allowing existing comparative advantage to determine the composition of production and exports, equal exchange rates for exports and imports and equality between domestic and world market prices.

22. Latterly, it has been recognized that Asia's success did not lie in State neutrality. States played an important role in fostering export competitiveness, using various mechanisms, including the maintenance of export friendly effective exchange rates and the granting of large subsidies to exporters. Trade policies were therefore part and parcel of broader national development strategies. This strategy goes very much against the contemporary paradigm concerning the merits of trade liberalization, which focuses excessively on removing the impediments to imports, but provide little guidance regarding how to strengthen export capacity and promote diversification. As the Mauritian example shows (see box 2 below) export diversification is rarely, if ever, achieved in a strictly laissez-faire policy environment.

Box 2
The case of Mauritius

The Mauritian economy has been a success story over the last two decades, witnessed by its high ranking in a number of indicators, including: the Trade Competitive Index; the Economic Commission for Africa's Institutional Sustainability Index (leading country); and the Economic Sustainability Index (fourth place). Its economy is structured around three pillars: sugar, export processing zones and tourism. Contrary to popular belief, the country has maintained a highly restrictive trade regime with its market relatively closed to imports. But its export sector has been kept fairly open by implementation of several instruments to segregate it from the import sector. Duty-free access was provided to all imported inputs, resulting in a competitive export sector; tax incentives were provided to firms operating in the Export Processing Zone and the labour market for the export sector has been segmented from the rest of the economy, with greater flexibility in the zone regarding overtime payments as well as the discharging of workers. This, combined with the country's ethnic diversity, which has attracted investment from the Far East, a stable political environment and sound macroeconomic policies, has resulted in a competitive trade environment.

Source: Economic Commission for Africa, 2003.

23. The words of the High-Level Panel on Financing for Development (the Zedillo report) are pertinent to this issue. The authors argued that a priority for any development round of the World Trade Organization would need to consider how to legitimate time-bound protection of certain industries by country in the early stages of industrialization:

> "However misguided the old model of blanket protection intended to nurture import substitute industries, it would be a mistake to go to the other extreme and deny developing countries the opportunity of actively nurturing the development of an industrial sector."[5]

VII. Focusing on export diversification

24. During the 1990s, it became commonplace to argue that trade has a central role in providing the basis for economic growth and development. Throughout the period of structural adjustment, the policies promoted by the international financial institutions were designed precisely to that end, to increasing the "openness" of African economies to trade. According to the World Development Indicators of the World Bank, based on trade as a percentage of GDP, African economies are already surprisingly open. This trade share is 62.2 per cent in Sub-Saharan Africa, actually above the world average of 57 per cent, and far above the average for Latin America and the Caribbean (35.9 per cent). Bearing in mind that informal trade (that is, not registered trade) is generally considered to be much higher in Africa than comparable regions, and the fact that the continent has been adversely affected by the deterioration in the terms of trade, Africa's degree of integration into the world economy is thus much higher in this respect than is commonly thought.

25. Africa's minor role in world trade essentially reflects Africa's small GDP, rather than a lack of openness per se. Contrary to popular belief, the volume of trade is not the primary challenge facing African policy makers. Rather, the issue is a qualitative one: although the volume of trade is only loosely related to economic success, econometric investigations reveal that the share of manufactured goods in total exports is a more significant indicator of economic success. Manufacturing is also one of the main vehicles for technological development and innovation, and an economy with a higher share of manufacturing in total value added is generaliy less exposed to external shocks, price fluctuations, climatic conditions and unfair competition policies.

26. It is not true that in Africa there has been no progress towards export diversification over the last two decades, it is simply that progress has been insufficient (see table 1 below). A few African countries, such as Uganda and Kenya, have increased exports by diversifying into non-traditional exports, typically, vegetables, fruits and flowers. Such achievements are not to be gainsaid. But particularly relevant are the experiences of a small number of countries that have successfully promoted manufacturing exports, such as Tunisia and Mauritius. Although no particular experience can be directly extrapolated, these cases can still provide useful contrasts and lessons for other developing countries in Africa.[6]

Table 1
Manufacturing measured as a percentage of export trade for selected African countries (1980-2001)

	1980	*1990*	*2001*
Algeria	0.3	2.6	*2.3*
Angola	12.9	0.1	-
Benin	3.4	-	6.2
Cameroon	3.8	8.5	4.7
Comoros	23.8	-	*8.2*
Côte d'Ivoire	4.7	-	*14.5*
Egypt	10.9	42.5	32.7
Ghana	0.9	-	15.8
Kenya	12.1	29.2	*20.8*
Mauritius	27.4	65.8	74.2
Morocco	23.5	52.3	*64.1*
Nigeria	0.3	-	*0.2*
Senegal	15.1	22.5	28.8
South Africa	18.2	21.9	59.4
Togo	10.6	9.1	49.7
Tunisia	35.7	69.1	*77.0*
Uganda	0.7	-	6.9
Zambia	16.0	-	12.7
Zimbabwe	35.8	30.9	*28.1*

Note: figures in italics refer to data for 2000.
Sources: World Bank, *World Development Indicators (2003)* and UNCTAD, *Handbook of Statistics (2003)*.

27. The experience of the more successful countries reveals that trade liberalization alone is unlikely to enable them to emerge as exporters of manufactured goods. In developing countries, which are poor in terms of infrastructure development, sound macroeconomic policies, openness and fiscal incentives are not enough. A concerted effort to focus on strengthening the supply-side response of African industries is therefore required. However modest its beginning, Governments need to develop a coherent industrial policy and, within it, articulate a well-defined role for the export sector. Providing some policy recommendations to this end is the main theme of the present report.

VIII. Identifying areas for policy action to strengthen trade performance: the Trade Competitiveness Index

28. Given the above challenges, a trade competitiveness index (TCI) for African countries is hereby introduced. The TCI is meant primarily as a tool for policy makers in Africa to enable them to identify where the competitive shortcomings of their countries lie in comparison to other African countries. The TCI is computed for a sample of 20 African countries. To draw valuable lessons from an intercontinental comparison, the sample includes: eight non-African countries; four Asian countries (India, Malaysia, Thailand and Indonesia); and four Latin American countries (Bolivia, Chile, Argentina and Brazil); all developing countries that had GDP per capita levels similar to African levels in the 1960s, but have since followed various developmental paths.

29. Using a total of 34 indicators, the TCI is divided into three components, each capturing a different dimension of trade competitiveness: a trade enabling index, reflecting the overall economic and political environment's conduciveness to trade; a productive resource index, measuring the availability of direct inputs to production, such as land and labour force; and an infrastructure index, measuring the availability of indirect inputs such as a physical infrastructure that enables the movement of goods and services. These three sub-indices received equal weighting to comprise the TCI, which in turn allows the identification of the most competitive countries in terms of trade as well as identification of bottlenecks to an improved trade performance.

30. The results reveal a number of important findings:

(a) Despite the usual notion that African countries are resource abundant, they have a relatively low score on the productive resource index. This can be explained by looking at the components of the index, which include data not only on natural resources, such as the renewable water resources, but also created resources such as the quality of the labour force. The policy implication is that more resources need to be dedicated in Africa to improving the quality of created assets and human capital;

(b) The analysis reveals that there is a positive relationship between the trade competitiveness index and index of export concentration, which reflects the degree of product diversification in the export structure of the country concerned. This implies that countries that are competitive tend to have lower export concentration and rely on a larger number of products for their export revenues. The challenge for African policy makers is providing the context for upward diversification, towards higher value-added goods and services with increased technological content;

(c) Variations in overall competitiveness are mostly driven by the trade-enabling environment, which captures the macroeconomic and political environment as well as policies conducive to trade. Crucially, the trade enabling index includes variables reflecting the extent to which a country has achieved good governance, in terms of government stability, bureaucratic quality and democratic accountability. It is not coincidental that the top scoring African countries in terms of a trade enabling environment are also the top scoring countries in terms of overall trade competitiveness. These countries have managed to diversify most and have the highest export of manufactured goods relative to GDP. Mauritius, South Africa,

Tunisia, Egypt and Morocco are the most competitive African countries, while Nigeria, Mali, Zimbabwe, Malawi and Ethiopia are the least competitive.

31. The comparison with the selected non-African countries reveals that labour force indicators are key determinants of trade competitiveness on a global scale: seven of the eight non-African countries dominate the overall trade competitiveness index due largely to a well-educated and healthy labour force. This suggests that while a pro-trade environment is critical, global trade competitiveness and, ultimately, greater integration into the world economy require increased efforts in educating the African people and improving their health.

IX. The fundamental role of an active employment policy

32. Equally essential, however, is job creation. There is no point in investing heavily in human capital through education and training schemes if no job opportunities are available. Regardless of the merits of policies of trade liberalization, the fact remains that in many African countries the reduction of tariff and non-tariff barriers has been associated with a sharp fall in employment, as consumers have switched from non-traded goods to imports. Policies are urgently needed to address the problem of employment generation, possibly the most pressing problem in Africa. One possibility, recently recommended by the United States Commission on Capital Flows to Africa, is to provide more active support for small and medium-size business. In recognition of their importance as creators of employment, and as potential seedbeds for technological acquisition and innovation, all industrialized nations offer financial and technical support to their small and medium-size businesses. Africa desperately needs to create national small business institutions, similar to the United States Small Business Administration, to coordinate comprehensive programmes of support to these enterprises. These small business institutions could provide streamlined access to: (a) assistance programmes that address the technical and managerial weakness of small and medium-size businesses; (b) financing programmes including loan guarantees, equipment and export finance; (c) coordination of linkages with multinational corporations; (d) basic information on market and export opportunities; and (e)"one-stop-shopping" for licensing, taxation and other regulatory matters.

33. For the poorest of the poor, these policy measures, which take time to implement, may not have a sufficiently direct impact on their situation. It is unrealistic to expect these policies, on their own, to make a significant dent in unemployment among the poor and unskilled. In such circumstances, State financing could be provided for public works projects (for example road building or irrigation works), especially during periods of economic recession. There are a wide range of public works programmes already in place in African Member States (see box 3 below). In Ghana, for instance, youth are employed in afforestration and urban sanitation programmes.[7] Although the schemes have met with varying degrees of success, a number of the countries in the region (for example Kenya and Ethiopia) have also implemented food for work programmes. These kinds of programmes need to be improved upon and should be extended as far as resources allow.[8]

Box 3
The Tunisian 21-21 Fund: tackling unemployment

In Tunisia where unemployment stood at 15 per cent in 2001, the Government has undertaken a range of measures, the most significant of which was the launching of the National Employment Fund (popularly known as the "21-21 Fund") in January 2000. Aimed at facilitating the integration of job seekers, particularly the young, into the labour market, its beneficiaries include all categories of the workforce, including unskilled workers.

The Fund uses a multi-pronged approach to address the unemployment issue. Its internship programme for disadvantaged youth under 20, most of whom have limited access to companies for various social and economic reasons, matches them with enterprises able and willing to provide training for a specified period of time and includes their transportation costs. For those with low educational attainment, training is provided to make them employable, and employment is eventually provided within the context of various public benefit works. University graduates can participate in advanced training programmes in computing and telecommunications; those with liberal arts backgrounds are trained in various fields, including pre-school teaching and participation in the national adult literacy programme. The most successful of the initiatives by the Fund is an aid programme to help potential entrepreneurs establish small businesses in collaboration with the Tunisian Solidarity Bank.

The Fund also provides financial assistance to the 35 public and private training centres by bearing the cost for the establishment of micro-enterprises and the set-up of incubators for companies. Approximately 204,000 people benefited from the Fund between January 2000 and November 2002; emphasis has been put on enterprise creation in areas where the economic fabric is weak as well as on training elsewhere.

Most of the beneficiaries have since established their own businesses or have found stable employment. The Fund makes its credit line available to guarantee commercial bank loans to programme graduates who start their own projects. The creation of the National Employment Fund follows the success of the National Solidarity Fund, whose primary objective is poverty alleviation.

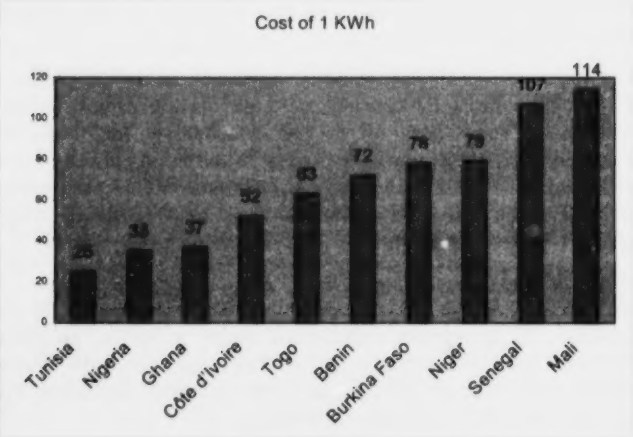
X. Confronting supply-side problems

34. To ensure greater export diversification, African countries need to identify key domestic obstacles to international business development and take appropriate measures to improve local conditions for business. Firm level surveys in countries including Senegal, Ghana, Uganda and Kenya have identified infrastructure constraint as a significant factor affecting export development. African countries

require good infrastructure facilities in order to compete effectively in the international market. Although many types of infrastructure, roads, air transport, railways and ports, are important, the present report highlights the energy sector and its role in facilitating export diversification.

35. Despite Africa's enormous potential for producing energy, many African countries are plagued by substandard infrastructure in this field. The African power sector is small in comparison with its geographic size and population. Africa's electricity generation was 479.8 terawatt-hours in 2001, representing only 3.1 per cent of world electric production — and even this very limited supply is prone to repeated failure as manifested by power rationing, brownouts and blackouts. A number of problems have reduced the ability of the sector to power Africa's export diversification drive. These include high system losses in transmission and distribution; unsustainable tariffs; climatic factors; poor technical, managerial and financial performance; and inefficient government intervention. Comparisons of unit costs between Tunisia, a country with an efficient State-owned energy sector and a well-diversified economy, and West Africa reveals unit energy costs that are more than twice as high in countries like Togo and Côte d'Ivoire, and more than four times higher in Senegal and Mali (see figure 3 below).

Figure 3
Cost of 1 kilowatt-hour in Tunisia in comparison to selected West African countries



36. The energy sector has not been able to attract the foreign direct investment (FDI) that many analysts consider as necessary to upgrade Africa's power network. Foreign direct investment in the power sector in Sub-Saharan Africa between 1990 and 1998 was $363.2 million, representing only 6 per cent of all infrastructure FDI flows to the region. Energy schemes involving foreign private investors have sometimes produced poor results, or provided services at an excessively high cost, an outcome obviously prejudicial to the poor.[9] It is worth recognizing, however, that the choices for African Governments are frequently difficult. On average, privatized

utilities have proved more efficient in extending coverage of services like water or electricity connections. But are host Governments prepared to accept tariff increases, with all the distributional consequences entailed, in return for higher coverage rates? For instance, a study of the options for Nairobi's water system by British company Halcrow Group in June 2001 concluded that a 40 per cent price increase would be required if any improvements to the capital's infrastructure were to be funded. Given the tight budgetary constraints under which the Governments of most least developed countries operate, is reform of the existing public sector services feasible over the short to medium-term? Moreover, as a recent United Nations report reminds us:

> "The growing tendency to leave even least developed countries to the mercy of the capital market to build power plants and upgrade their telecommunications facilities has led to growing under-provisioning of investments in this sector in the least developed countries. Not all least developed countries can access foreign direct investment in these areas or access it with sufficient urgency to meet their immediate demand for power or water."[10]

37. To achieve a better utilization of power resources, a number of policy guidelines are recommended:

(a) Although not always the case (see the Tunisian example above), direct government control of the power sector has often produced disappointing results. One policy option is the transformation of power companies into independent and self-reliant corporations that can still be under government ownership. The success and efficiency of power companies will, however, depend on the extent to which they incorporate economic considerations in their operations;

(b) African countries should promote energy efficiency. Energy efficiency reduces operating costs, enhances economic efficiency and improves the productivity and international competitiveness of energy consuming companies. An energy efficient programme should include promotional and information dissemination activities to increase energy conservation awareness and incentives to increase the ability and willingness of energy users to implement energy conservation measures;

(c) Rural electrification programmes can also help promote the development of the energy sector and ensure greater export diversification. African Governments could promote rural electrification by playing a more aggressive and transparent role of promoting smaller village-based energy systems;

(d) The increased reliance on private sector involvement in the energy sector requires good and credible regulation. Efficient regulation should prevent abuse of monopoly power and limit price increases to levels that are compatible with profit margins. To perform effectively, it is essential that regulatory bodies be independent, distanced from political, corporate and other pressures;

(e) Finally, the promotion of regional integration in energy services would help promote the development of the energy sector in Africa. A study by the Southern African Development Community and the World Bank suggested that an estimated saving of $1.6 billion over 10 years could be realized through optimal use of regional electricity resources and installation in Southern Africa. The development of regional markets in energy would require common regulations for international exchanges.

XI. Towards an effective strategy for trade facilitation

38. Trade facilitation has been defined both narrowly and broadly. The World Trade Organization, the United Nations Conference on Trade and Development (UNCTAD) and OECD have restricted the scope of their definitions to the relatively free movement of goods, and, more specifically, to customs procedures and technical regulations that can impair or delay trade. The World Bank, however, takes a broader approach to its trade facilitation programme, which covers reforms in customs, regulatory frameworks and standards. In the present report a broader definition of trade facilitation is forwarded.

39. Many African countries acknowledge the benefits that could arise from improved trade facilitation and the economic gains that could be generated, including: promotion of trade and investment; lower transactions costs; improved revenue collection; and better allocation of resources. In this regard, efforts need to be intensified in order to improve the state of trade facilitation in the African continent. This entails the strengthening of Africa's infrastructure network and harmonizing and implementing regional facilitation instruments, including customs and administrative procedures.

40. The generally low density and quality of transport infrastructures in Africa raises transactions costs for trade substantially. Transaction costs are higher in landlocked African countries, impeding the competitiveness of these countries. The ability of landlocked countries to trade relies on the existence of efficient and easily accessible transit corridors. This implies that, in addition to their own infrastructures, landlocked economies need good and reliable infrastructures in neighbouring countries over which they have little control.

41. In addition, efforts have been made at regional, subregional, multilateral, bilateral and national levels to facilitate trade in Africa. The Common Market of Eastern and Southern Africa (COMESA), the Southern African Development Community (SADC), the Economic Community of West African States (ECOWAS), the West African Economic and Monetary Union (UEMOA), and the Economic and Monetary Community of Central Africa (CEMAC), among other regional economic communities, have worked to harmonize trade facilitation procedures in their subregions and to facilitate transport links. Cameroon has signed conventions on the transportation of goods by land with its landlocked neighbours, Chad and the Central African Republic. The Tunisia Trade Net, an automated system introduced in 2000, which provides a one-stop trade documentation-processing platform connecting the principal actors of international trade, is expected to reduce shipment clearance from an average of 8 to 3 days and to result in a productivity gain of 7 per cent. Several African countries are also using the Automated System for Customs Data introduced by UNCTAD.

42. At the multilateral level, trade facilitation was placed on the agenda of multilateral trade negotiations and the World Trade Organization at the first Ministerial Conference of the Organization, held in Singapore in December 1996, as one of the four "Singapore issues" despite strong opposition from developing countries, including those from Africa. The opposition and concerns of many developing countries to agreeing to develop a "multilateral framework" on trade facilitation was not due to lack of appreciation of the importance and role that such a framework could play in promoting development, but mainly to the lack of adequate

human, financial and technical capacity to deal with the issue in a multilateral environment.

XII. Mobilizing domestic resources, a continuing priority

43. Faced with insufficient external resources, it is a clear priority for African Governments to promote domestic resource mobilization. Savings and investment to GDP ratios remained low during 2001 (the latest year for which data are available), and generally well below the levels compatible with achieving the Millennium Development Goals on growth and poverty reduction. No less than 27 countries in the region had savings ratios below 10 per cent in 2001, indicating a huge shortfall in the resources needed to catalyse development. Although private investment has increased, investment rates have yet to recover from the collapse that took place during the processes of structural adjustment. At that time, public investment fell sharply, and it has not been adequately compensated for by rising private investment. Given the importance of complementarities and synergies between public and private investment, what is clearly required is a recovery in public sector investment in essential infrastructure, health and education.

44. The potential role of African capital markets is also of vital importance. There is a long-standing debate over the best way of financing the corporate sector, with some authors stressing the difficulties associated with an excessive dependence on stock market financing in poor developing countries.[11] The experience of Africa bears out some of these criticisms. Although small by global standards, Africa's capital markets have shown considerable growth over the last decade. Of the 17 out of 18 African stock markets for which data is available, market capitalization as a percentage of GDP rose significantly in 16 countries between 1990 and 2002. Against the poor performance of developed country stocks over the last two years, many African stock markets have performed relatively well, reflecting Africa's partial insulation from global financial shocks due to the continent's low level of integration into the world economy. Large increases in the value of stocks traded have occurred primarily in the regional powerhouses, Egypt, Morocco and South Africa.

45. Overall, however, African capital markets remain marginal in the global and emerging markets: their share of world market capitalization fell from 1 per cent in 1992 to 0.7 per cent in 2001. This lacklustre performance is the result of external and institutional constraints that limit the growth of African stock markets. Political instability and patchy macroeconomic performance block the development of vibrant capital markets, and stock market infrastructures, including settlement and trading mechanisms, are often poorly developed. Markets frequently suffer from severe informational deficiencies and ineffective regulatory regimes.

46. In view of the relatively marginal role of African stock markets in financing the productive system, strengthening the domestic banking system is clearly a priority area. Despite the pressure over the last two decades on African countries to liberalize their financial sectors, performance of the banking sector has not significantly improved, and portfolios continue to be dominated by non-performing loans and excess liquidity. This performance is often contrasted with the relatively dynamic performance of the informal financial system, which has expanded mainly in response to the financial requirements of informal sector businesses. Gaps in

financial services have also emerged. A number of authors have talked of Africa's "missing middle", in the sense that the needs of many potential borrowers are either too large for the informal lenders or too small for the formal lenders.[12] And none of this helps the cause of export diversification. Policy makers urgently need to address the issue of how to reform the banking sector so that it may fulfil its social and developmental function adequately.

XIII. The importance of fiscal reform against a backdrop of trade liberalization

47. The financial dependence of African Governments on taxation from trade raises the problem of how to maintain the fiscal base and preserve macroeconomic stability in the face of trade liberalization. In other regions, this issue is receiving increasing attention from policy makers. For example, all the countries in Latin America, except for El Salvador, have either passed tax reforms or are in the process of doing so.[13]

48. The issue is especially important for Africa. The overall tax base is excessively low. And taxes on international trade have been an important part of fiscal revenue in African countries where tax administration is inefficient. In Africa as a whole international trade taxes generated, on average, 28.2 per cent of total current revenues over the last decade; in Sub-Saharan Africa the share is 30.5 per cent. This compares to 0.8 per cent for high-income OECD countries, 11.5 per cent for upper-medium income countries, 18.42 per cent for lower medium-income countries, and 22.5 per cent for low-income countries. In addition, while the data show a decreasing dependence on trade taxes worldwide, in Africa the share has fluctuated around a flat or even slightly increasing trend.

49. Trade liberalization is therefore a potential source of fiscal instability for African countries. Revenue-collecting concerns are often mentioned as a reason for resistance to trade policy reform in low-income countries. Despite this, some components of trade liberalization packages are likely to have a positive impact on revenues. These include the replacement of non-tariff barriers by lower tariff equivalents and the elimination of tariff exemptions and trade-related subsidies. Moreover, tariffs cuts can also increase total revenues if they generate a sufficiently large increase in trade flows. Trade liberalization measures can also be combined with other tax and fiscal reforms to help buffer the revenue impact of trade liberalization.

50. Fiscal stabilization remains problematic for most African countries. Despite improvements in the second half of the 1990s, the average continental fiscal deficit (excluding grants) in 2002 and 2003 was around 7 per cent of GDP. The factors that determine fiscal deficits include macroeconomic and growth performance, shocks to the terms of trade and political factors. After controlling these determinants, the effect of trade liberalization on revenues and the fiscal deficit depends on the existing level of trade restrictions. When trade restrictions are initially very high, trade liberalization increases trade tax revenues and reduces the deficit. Conversely, when initial trade restrictions are low, further liberalization results in smaller revenues and a larger deficit, unless some appropriate policy response is implemented. Initial liberalization is therefore less likely to pose a fiscal problem than liberalization at later stages. Because African countries have already carried out trade liberalization during the 1990s they are likely to face significant revenue reductions as a result of further liberalization (see box 4 below).

Box 4

Economic partnership agreements and their fiscal implications

One of the most important policy initiatives in recent years has been the planned economic partnership agreements between the European Union and Sub-Saharan Africa. The agreements are an extension of the Cotonou Agreement with the African, Caribbean and Pacific countries, and were initially discussed for the first time in 2000. Despite new initiatives on the part of the European Union (such as the aforementioned "Everything but Arms" agreement), generally speaking the results from preferential agreements have been disappointing. For instance, over the first two decades of preferential access to the European Union market under the Lomé Accords, the exports of the African, Caribbean and Pacific countries to the European Union market fell from 6.7 per cent of world exports in 1975 to 2.7 per cent in 1995. There are, of course, explanations for this: most poor African, Caribbean and Pacific countries have been locked into patterns of exports based on primary exports whose share in world trade has been suffering a decline. Clearly, however, the concessions for the African, Caribbean and Pacific countries were not capable of offsetting this structural imbalance.

The economic partnership agreements initiative should thus be seen as a result of the growing frustration with preferential access agreements and a rethinking on the part of the European Union regarding trading policy towards the poorest developing countries. The planned establishment of free trade agreements with the European Union under the economic partnership agreements represents an enormous challenge to African countries. It will oblige them not only to liberalize their trade regime with the European Union completely, but also to instigate a whole number of institutional and regulatory reforms. This is seen as one of the most important benefits of the economic partnership agreements, instilling greater "discipline" in the process of institutional reform and locking Sub-Saharan countries into a reform programme, with the ultimate objective of making their economies more competitive internationally.

However, one particular area of concern is the impact of the economic partnership agreements on government revenues. Revenues from tariffs still amount to 2 per cent of GDP in the median Sub-Saharan country, and for some countries that figure reaches 4 to 6 per cent of GDP. For the countries most dependent on trade with the European Union, including the Central African Republic and Uganda, the loss of tariff revenue on imports could affect a very high percentage of total government revenue, reaching as much as 20 per cent.

The European Union is aware of this problem and has promised substantial financial help to aid industrial restructuring and compensate for the lost tariff revenues. Unfortunately, the precedent of the European-Mediterranean agreements, coupled with the relatively low level of funding provided by the European Union for the upgrading of the programmes in Northern Africa, does not provide the basis for much

optimism. African countries are aware that the European budget is already overstretched by the enlargement of the European Union and by numerous other commitments. The European Union may not, therefore, be able to meet its commitment of substantial economic support to finance the transition period. There are also concerns that any additional financial help could come attached with new conditionalities. These points explain in large measure the tepid reaction to the initiative of some African, Caribbean and Pacific countries and Sub-Saharan countries. Negotiations were originally scheduled to start from September 2003, but the Pacific islands argued that they would not be ready for negotiations until November 2004. West African representatives (UEMOA and ECOWAS) actually walked out of the initial negotiations in late 2003 and demanded an European Union aid commitment upfront before re-entering negotiations.

51. In general, the African countries that made the fastest progress on trade liberalization over the last 10 years saw a significant decrease in revenues from international trade taxes. But in some, including Morocco, Ghana, Tunisia and Senegal, this did not translate into higher deficits. Their experience suggests that policy responses might be used to buffer the negative fiscal impacts of trade policy reforms. Firstly, trade liberalization should be coordinated with measures on the revenue and spending side of the budget, including raising domestic indirect and direct taxes, strengthening tax administration and collection and improving the effectiveness of public spending. Secondly, a sound macroeconomic environment is critical to preventing fiscal distress during trade liberalization.

XIV. Conclusions: the overriding need for a strategic approach to trade policy

52. The progress that Africa has made in the last few years is evident in the information provided in the present report. After the disappointing economic performance of the 1980s and 1990s, we have witnessed a return to positive rates of per capita economic growth in most of the continent, with an acceptably good macroeconomic performance. However, those rates of growth are still well below the 7 per cent needed to fulfil the Millennium Development Goals. Moreover, the economic recovery is fragile, in some parts of Africa it is the result of better climatic conditions and harvests, something which obviously cannot be counted upon in the future. A number of political and military conflicts also continue to jeopardize the achievements of recent years.

53. We have argued that in order to consolidate improved economic performance, there are various long-term priorities that need to be addressed, the chief ones being higher rates of savings and domestic investment, greater investment in human capital and more dynamic export performance. We have attempted to signpost the way towards policies for strengthening the competitive capacity of the African economies. A more concerted effort on the part of African policy makers for promoting export capacity and facilitating structural diversification, through the adoption of a coherent industrial policy, is required. In the final analysis, this amounts to a reconsideration of the way in which Africa has, up until now,

attempted to achieve its integration in the world economy. This is implicit in the context of initiatives such as the New Partnership for Africa's Development, but in our view it is also something that needs to be spelled out more explicitly in the future.

54. Despite the main argument presented in the present report, that, in the final resort, successful export promotion and structural change is dependent upon African Governments themselves, it must be recognized that for most African countries the resource requirements for diversification are beyond what could possibly be mobilized at the domestic level. In 2003, UNCTAD forwarded the need to work out a financing mechanism at the international level to help these countries develop a system of supply rationalization and diversification into other products in order to remove excess supply of these traditional commodities from the markets. According to UNCTAD, this might necessitate revisiting the concept of a "diversification fund" for African countries.[14]

55. In the meantime, there is an urgent need for Africa to achieve more tangible results through the multilateral trading system. The provision of a more accommodating international context for African exports, through the removal of trade impediments by the industrialized countries, is a sine qua non for African development. Policy makers in Africa and elsewhere should be aware of the urgency of these reforms. Over the short to medium term, African countries must place the emphasis on enhancing their countries ability to compete. Meanwhile, the door should not be closed through unreasonable limits on special and differential treatments required in aiding African countries to participate in the world economy. Over the long term, if the multilateral system of trade liberalization does not produce the desired results, despite credible efforts by African countries, then there is a very real possibility of a backlash against trade liberalization and the multilateral system. While trade liberalization has an important role in an overall strategy for economic and social development, the overarching principle must be adherence to policies that produce substantial results within a reasonable time frame. African leaders, and policy makers in the industrialized countries, should be conscious of the fact that time is running out.

Notes

[1] Fosu, Augustin Kwasi, Political Instability and Export Performance in Sub-Saharan Africa, *Journal of Development Studies*, vol. 39, No. 4.

[2] See www.allafrica.com.

[3] UNCTAD, *Economic Development in Africa: Trade Performance and Commodity Dependence*, New York and Geneva, 2004.

[4] World Bank, *Can Africa claim the 21st century?*, 2000.

[5] See A/55/1000, sect. 2.

[6] The case of Togo also stands out as a country that has apparently achieved a higher level of manufactured exports than the norm for Africa. However, this figure is principally the result of trans-shipment rather than the diversification of the economic structure towards manufacturing.

[7] See Kasirim Nwuke, "Youth employment in Africa", a background paper for the Youth Employment Summit, Economic Commission for Africa, September 2002.

[8] A good example of this kind of model is the Mahararastra Employment Guarantee Scheme in India, financed by a consumption tax in urban areas, which provides a minimum wage for rural workers during periods of economic hardship.

[9] On more than one occasion the World Bank has questioned deals reached between multinationals and African Governments. Such was the case regarding Enron's $800 million deal with the Nigerian Government. The World Bank and other foreign consultants were widely reported to have objected to the terms of the agreement on grounds that in haste to solve the electricity supply problem the Nigerian Government had offered terms that were exceedingly favourable to Enron (Economist Intelligence Unit, 2000).

[10] A/CONF.191/IPC/16, para. 59.

[11] Ajit Singh and Bruce A. Weisse, *Emerging stock markets, portfolio capital flows and long-term economic growth: micro and macroeconomic perspectives, World Development*, vol. 26, No. 4, 1998.

[12] See MacHiko Nissanke and Ernest Aryeetey, "Financial Integration and Development: Liberalization and reform in Sub-Saharan Africa", Routledge Studies in Development Economics, 1998.

[13] See Economic Commission for Latin America and the Caribbean, *Current conditions and outlook, Economic Survey of Latin America and the Caribbean 2002-2003* (E.03.II.G.111).

[14] UNCTAD, *Trade Preferences for LDCs: An Early Assessment of the Benefits and Possible Improvements*, New York and Geneva, 2003, and *The Least Developed Countries Report, 2002: Escaping the Poverty Trap*, New York and Geneva, 2002.

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Summary of the economic and social survey of Asia and the Pacific, 2004

Summary

Developing countries in the Economic and Social Commission for Asia and the Pacific (ESCAP) experienced strong, broad-based growth in 2003 combined with low inflation. ESCAP developing countries as a group are growing faster than the global economy as well as other groups of developing countries. Growth is becoming more autonomous, driven increasingly by forces within the region, such as intraregional trade and strong domestic demand, with China's economy playing a major role in the former. Growth in the developed countries was above expectations, as Japan's economy recovered strongly in 2003. Prospects for 2004 indicate a continuation of existing trends on the assumption that the region experiences no negative shocks, the unravelling of global imbalances does not generate major disruptions in the financial markets and the economies of the region are able to maintain sound macroeconomic fundamentals, while implementing ongoing programmes of reform and sustaining competitiveness at the same time.

Despite the region's robust economic growth and significant strides in poverty reduction over the past several decades, poverty continues to be a major development challenge for many countries in the region. The complexity and multidimensional nature of poverty make tackling it a difficult task. That is where well-designed national strategies for poverty reduction, supported by appropriate institutions and political will, make a difference. Some countries have their own national poverty reduction strategies while others have adopted the Poverty Reduction Strategy Paper (PRSP) approach to focus attention on measures to tackle poverty. A study of 13 countries which have adopted the PRSP approach shows that it could well be an

* E/2004/100.

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effective tool for poverty reduction if it is aligned explicitly with the Millennium Development Goals. There should be better analysis of the root causes of poverty, fuller consideration of the downside risks of internal and external shocks and more integration with budgetary and parliamentary processes. As a major stakeholder in the global efforts to reduce poverty, the international community can play a critical role in facilitating national efforts.

The present document is based on the *Economic and Social Survey of Asia and the Pacific 2004*.

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I. Implications of recent economic and social developments

1. The *Economic and Social Survey of Asia and the Pacific 2004* looks at trends in the regional economy in 2003, prospects for 2004 and the policy choices facing the region. It also considers longer-term issues relating to poverty reduction strategies in the region in the light of the multidimensional nature of poverty.

2. The *Survey* states that in 2003 the developing countries in the region of the Economic and Social Commission for Asia and the Pacific (ESCAP) continued to show strong growth, exceeding the 2002 performance by almost half a percentage point. The performance in 2002 itself had significantly exceeded expectations so that by the end of 2003, following the 2001 slowdown, ESCAP developing countries had enjoyed two years of buoyant growth combined with low inflation. From a regional perspective, growth was broad-based, with all subregions but one experiencing higher growth and was not affected significantly by the war in Iraq and the severe acute respiratory syndrome (SARS) crisis. The experience with inflation was mixed, with two subregions having somewhat higher inflation in 2003 compared with 2002, albeit at a low absolute level, with the exception of some of the Pacific island economies (see table 1).

3. Buoyant growth in the ESCAP developing countries note only represents an impressive turnaround after the 2001 slowdown, but also shows that the process is becoming less dependent upon global economic trends. ESCAP developing countries as a group are growing faster than both the global economy and other groups of developing countries. As such, growth is becoming more autonomous in that it is the result primarily of forces within the region, such as intraregional trade and strong domestic demand, although exports to the rest of the world continue to play a significant part in sustaining the overall momentum of growth.

4. China's remarkable performance has been central in sustaining the momentum of growth in the region as a whole, with its gross domestic product (GDP) expanding by just under a quarter in only three years (2001-2003) on the basis of strong investment and consumption demand. During this period, China also increased total imports by more than $160 billion, some two thirds of which have come from the region. China is now the fourth-largest trading nation in the world, helping thus to stimulate output growth across a broad front in the regional economy. Similar trends are visible in several other economies of the region, where robust growth has resulted from a combination of higher net exports and domestic demand. The former is the result partly of higher commodity prices and partly of higher growth of information and communication technology components plus a wide range of finished consumer goods, especially household electronics. Higher exports have also been the result of strong demand from within the region and have been further boosted by stronger growth in the United States of America, to which approximately a fifth of the region's exports remain destined. Robust domestic demand owes much to higher fiscal spending as well as to increased corporate and household expenditure, which has been facilitated by the low-inflation and low-interest rate environment.

Table 1
Selected economies of the ESCAP region: rates of economic growth and inflation, 2002-2006
(Percentage)

	Real GDP					*Inflation*[a]				
	2002[b]	*2003*[c]	*2004*[c]	*2005*[c]	*2006*[c]	*2002*[b]	*2003*[c]	*2004*[c]	*2005*[c]	*2006*[c]
Developing economies of the ESCAP region[d]	5.7	6.0	6.2	6.0	6.0	5.5	3.6	3.0	2.7	2.3
South and South-West Asia[e]	5.2	6.6	5.8	6.3	6.4	14.4	10.6	7.9	6.5	5.0
Bangladesh	4.4	5.3	5.7	6.0	6.5	2.4	5.1	4.5	4.0	4.0
Bhutan	7.7	7.0	7.5	8.0	9.0	2.7	3.6	..	..	..
India	4.3	7.5	6.0	6.6	6.7	4.0	4.8	4.0	3.5	3.0
Iran (Islamic Republic of)	6.5	6.9	7.1	8.1	8.2	15.8	16.8	17.0	16.0	13.0
Nepal	-0.6	2.4	3.5	4.5	..	2.9	5.0	4.8	..	..
Pakistan	3.4	5.1	5.3	5.8	6.0	3.5	3.1	4.0	4.0	4.0
Sri Lanka	4.0	5.5	6.0	6.5	7.0	9.6	6.3	6.0	5.5	5.0
Turkey	7.8	5.3	5.1	5.1	5.1	45.0	25.3	14.4	9.8	6.2
South-East Asia	4.2	4.5	5.8	5.7	5.8	4.6	3.3	3.7	3.7	3.1
Cambodia	5.5	5.0	5.6	5.5	..	3.4	1.7	4.3	5.0	..
Indonesia	3.7	4.1	4.8	4.4	4.5	11.9	6.6	6.2	6.0	4.1
Lao People's Democratic Republic	5.9	5.9	6.1	6.0	6.3	10.6	13.5	9.0	5.0	5.0
Malaysia	4.1	5.2	5.5	6.0	5.5	1.8	1.2	1.8	2.2	2.0
Myanmar	5.3	5.1	4.3	..	..	57.1	52.8	44.0	40.0	..
Philippines	4.4	4.5	5.4	5.8	6.3	3.1	3.1	4.5	4.0	3.5
Singapore	2.2	1.1	4.7	4.4	4.9	-0.4	0.5	1.1	1.5	1.9
Thailand	5.4	6.3	8.0	7.5	7.5	0.7	1.8	2.4	2.5	2.8
Viet Nam	7.0	7.2	7.5	8.0	8.0	3.9	3.0	4.3	4.8	4.9
East and North-East Asia	6.4	6.0	6.6	6.1	6.2	0.1	1.4	1.3	1.2	1.2
China	8.0	9.1	8.5	8.0	7.8	-0.8	1.2	1.0	0.8	0.5
Hong Kong, China	2.3	3.0	5.1	4.0	3.4	-3.1	-2.6	-0.5	0.3	1.0
Mongolia	4.0	5.0	5.3	5.5	5.5	1.5	5.0	5.0	5.0	5.0
Republic of Korea	6.3	3.0	4.5	4.2	5.0	2.7	3.6	2.7	2.4	2.5
Taiwan Province of China	3.6	3.3	5.4	4.9	4.7	-0.2	-0.3	0.4	0.9	1.0
North and Central Asia	5.4	7.7	5.1	4.6	4.2	14.3	11.5	10.6	8.8	8.1
Armenia	12.9	13.9	7.7	7.5	..	1.0	4.7	3.3	4.0	..
Azerbaijan	10.6	11.2	8.7	12.0	..	2.8	2.2	3.0	3.6	..
Georgia	5.6	8.6	6.5	12.0	..	5.7	4.8	5.2	6.0	..
Kazakhstan	9.8	9.2[f]	8.3	9.5	6.5	6.0	6.4	6.4	6.4	6.0
Kyrgyzstan	-0.5	6.7	4.4	5.5	..	2.1	3.1	3.5	3.6	..
Russian Federation[g]	4.7	7.3	4.8	4.1	4.1	15.1	12.0	11.1	9.0	8.2
Tajikistan	9.5	10.2	6.0	6.0	..	10.2	17.1	15.0	10.0	..

	Real GDP					Inflation[a]				
	2002[b]	2003[c]	2004[c]	2005[c]	2006[c]	2002[b]	2003[c]	2004[c]	2005[c]	2006[c]
Turkmenistan	21.2	23.1	9.8	10.0	..	10.6	10.5	11.5	12.0	..
Uzbekistan	4.2	4.4	3.0	3.0	..	24.2	13.9	10.0	11.0	..
Pacific island economies	0.5	2.8	3.1	2.2	2.5	8.4	12.7	7.9	..	..
Cook Islands	2.2	1.8	0.2	..	..	3.9	2.4	1.8	..	..
Fiji	4.1	5.0	4.1	3.5	3.6	0.8	3.8	3.0[b]	..	..
Papua New Guinea	-0.8	2.0	2.8	1.7	2.1	11.8	17.5	10.1	11.8	..
Samoa	1.8	3.5	3.5	..	..	8.1	4.1	2.8	..	..
Solomon Islands	-2.0	1.9	3.1	..	..	9.8	12.1	11.0	..	..
Tonga	1.6	2.0	2.6	..	..	10.3	10.5	13.8	..	..
Vanuatu	-2.8	1.0	2.0	2.6	2.8	2.2	2.5	2.9	..	..
Developed economies of the ESCAP region	-0.1	2.7	2.2	1.6	1.1	-0.6	-0.1	0.0	-0.05	-0.05
Australia	3.6	2.8	3.6	3.7	3.7	3.0	2.7	2.3	2.7	2.5
Japan	-0.4	2.7	2.1	1.4	0.9	-0.9	-0.3	-0.2	-0.3	-0.2
New Zealand	4.2	2.7	3.1	3.1	3.2	2.6	1.7	2.2	2.4	2.3

Sources: ESCAP, based on national sources; International Monetary Fund, *International Financial Statistics*, vol. LVI, No. 12 (December 2003); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2003* (Asian Development Bank, 2003) and *Asian Development Outlook 2003 Update* (Asian Development Bank, 2003); Economist Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2003 and 2004), various issues; and web site of the Interstate Statistical Committee of the Commonwealth of Independent States, www.cisstat.com, 4 February 2004.

Note: Data correct as at 4 March 2004.

[a] Changes in the consumer price index.

[b] Estimate.

[c] Forecast/target.

[d] Based on data for 38 developing economies representing more than 95 per cent of the population of the region (including the Central Asian republics); GDP figures at market prices in United States dollars in 2000 (at 1995 prices) have been used as weights to calculate the regional and subregional growth rates.

[e] The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2003/04 = 2003 for India, the Islamic Republic of Iran and Myanmar; and fiscal year 2002/03 = 2003 for Bangladesh, Nepal and Pakistan.

[f] January-November.

[g] In case of inflation, figures for 2002-2003 refer to year-end rates.

[h] Year-end figure.

5. Although the prospects for each subregion are different, broadly speaking, the trends outlined above are expected to continue over the next 12 months in the ESCAP region as a whole; this is subject to the caveat that there are no new negative shocks to the region's economy in 2004. The expectation is that, barring any significant negative shocks, the collective GDP growth rate in the ESCAP developing countries should be the same in 2004.

6. In this context, it is worth noting that at the time of writing, avian influenza had affected 10 economies in the region, mainly in East and South-East Asia, resulting in the culling of millions of chickens on poultry farms across the region and in a number of deaths of human beings. The future course of this problem, particularly its wider economic repercussions in the region, is difficult to predict with precision for the time being. However, assuming that the disease remains

confined to poultry farms and is contained, say, by the end of April, its impact on regional growth is likely to be negligible and could even be made up by faster growth in the second half of the year, as happened with SARS in 2003.

7. Nevertheless, this optimistic scenario should be qualified with risks that could operate on the downside. In the first place, from a global standpoint, the latter part of 2003 witnessed the emergence of major global imbalances. The unravelling of those imbalances, especially in the form of rapid fluctuations in exchange rate parities, could spill over into greater instability in the financial markets, thereby undermining business and consumer confidence alike. Second, the danger of protectionist tendencies cannot be ruled out, given the implicit changes in relative competitiveness via exchange rate changes superimposed upon the failure of the World Trade Organization negotiations at Cancún, Mexico, in September 2003. Third, the stimulation of domestic demand by higher fiscal spending and low interest rates for three years or more has raised both public debt and personal indebtedness to uncomfortably high levels in a number of economies. Many of them thus do not have significant additional scope to stimulate growth further by these means. Fiscal consolidation and some degree of monetary tightening may soon become unavoidable. The following paragraphs outline briefly the performance and prospects for each subregion, followed by a discussion of the principal policy issues facing the region in the near term.

8. In East and North-East Asia, the rapid growth of the Chinese economy was not able to offset fully the marked slowdown in the Republic of Korea and weaker growth in Taiwan Province of China. Hence, it was the only subregion to experience a slowdown in the overall GDP growth rate in 2003 compared with 2002. Inflation rose, but at 1.4 per cent it remains low by historical standards and lower than in the other developing economies of the region. Prospects for 2004 are for a modest acceleration in the collective growth rate even though China's economy is expected to slow marginally from its present high rate of expansion. Thus, the pickup in regional growth will be on account of the higher momentum of development in the other economies of the subregion.

9. Despite the robust GDP growth, persisting and rising fiscal deficits are the central near-term policy issue of concern in the subregion. Domestic saving rates are high and financing these deficits does not pose an immediate problem. However, the effective pre-emption of resources on a large scale by the Governments of the subregion reduces the policy space to address urgent problems in the financial sector, as, for instance, in China, or to promote structural change and improve competitiveness, as, for instance, in Hong Kong, China, and the Republic of Korea. Moreover, the accumulating public debt is almost certainly bound to create upward pressure on interest rates in due course, thus putting at risk long-term investment expenditure in the various economies. Some restructuring and reform of the fiscal system are needed to stabilize the public debt-to-GDP ratio over the medium term. Furthermore, a shift from indirect to direct taxes is needed on equity grounds.

10. Collective GDP growth in North and Central Asia accelerated by an impressive 2.5 percentage points in 2003. The already high rates of growth prevailing in the smaller economies, such as Armenia, Azerbaijan, Georgia, Tajikistan and Turkmenistan, went up further in 2003; Kazakhstan continued to make progress in developing its energy resources and maintained its robust growth of recent years; Kyrgyzstan emerged smartly from negative growth; and Uzbekistan improved upon

its somewhat modest 2002 growth rate. The economy of the Russian Federation exceeded all expectations by achieving growth considerably in excess of the rate predicted as recently as six months ago and 2.6 percentage points more than in 2002. This stellar performance was driven by the traditionally strong energy and other natural resource sectors, aided by the continued diversification of the economy. Overall industrial production stood nearly 8 per cent higher in December 2003 on a year-on-year basis. Prospects for 2004, however, suggest that current rates of growth are unlikely to be sustained, with all economies expected to experience some slackening in the pace of growth in the coming months as energy and commodity prices soften.

11. This subregion's economies in transition face a very different set of qualitative issues of day-to-day management and of long-term development compared with the other ESCAP subregion. Transition from the command economy to a market-based one is taking longer than initially perceived. Deregulation of the price system is still incomplete and progress in reducing the role of the Government in production and distribution has some way to go. Deregulation of the price system is needed to eliminate repressed price pressures and achieve and maintain longer-term macroeconomic stability. Meanwhile, improved policy transmission is predicated on a reduction in the role of the Government and the establishment of stronger oversight institutions accompanied by the wider application of market-sensitive prices and instruments. Progress is being made on both fronts, as can be seen in the declining rates of inflation, lower fiscal deficits and improved current account positions in all except three countries in North and Central Asia. This progress is providing greater stability in exchange rates and a more stable environment for investment, both domestic and foreign. However, institutional progress has been slower and more uneven, especially in the financial sector, a key interface between the real economy and the saving and investment decisions of individuals. Market signals tend to operate poorly in capital allocation decisions, leading to waste and inefficiency.

12. The Pacific island economies emerged from two years of recession in 2003 as higher agricultural commodity prices stimulated output growth in the subregion. At the same time, however, inflationary pressures intensified, especially in the larger economies of Papua New Guinea and Fiji, on account of higher energy prices feeding into higher production and transport costs. Prospects for 2004 suggest an easing of both GDP growth and price pressures.

13. Several economies are running fiscal deficits and remain dependent upon outside assistance for budgetary support, a phenomenon that remains a key area of concern in this part of the world. The existence of inefficient State-owned firms and poor governance aggravates the fiscal problem significantly, while the shortage of public resources has meant chronic underinvestment in physical infrastructure, especially communications, a critical necessity given the physical remoteness and vulnerability to natural disasters of the island economies. The aggregate impact of these shortcomings has led to an increase in poverty and growing social instability in several parts of this subregion. Substantial and sustained investment in physical infrastructure and in education and health facilities is vitally needed to improve economic performance and the quality of life of the citizens of the Pacific island countries in the coming years.

14. In South and South-West Asia, there was a marked improvement in the collective GDP growth rate in 2003, compared with 2002, along with the abatement of inflationary pressures over much of the subregion. The higher GDP growth was almost exclusively accounted for by India, the largest economy in the subregion, which improved its GDP growth rate by over 3 percentage points. Pakistan, Bangladesh and Sri Lanka also experienced better GDP growth rates to varying degrees. The smaller economies likewise did well, with Nepal emerging from negative growth in 2002. The improved growth performance in India and Pakistan was occasioned by more favourable weather, which aided strong output growth in agriculture. Exports also benefited, particularly in Pakistan. Higher output and better commodity prices raised agricultural incomes and this, in turn, stimulated the production of manufactured goods. Investment levels also went up in these two economies. Elsewhere, the Islamic Republic of Iran too improved on its 2002 performance on the basis of strong demand and continuing high prices for oil and gas in 2003. Turkey's economy, however, registered a fairly sharp slowdown, primarily on account of negative growth in agriculture. Prospects for 2004 are for an easing of the collective growth rate of the subregion. India's agricultural sector is expected to slow somewhat after its impressive performance in 2003 and Turkey's economy is expected to come up against sluggish growth in the European Union, its principal trading partner.

15. Despite steady GDP growth over the last three years, this subregion is faced with a number of daunting challenges. For instance, income poverty levels remain high and access to essential social services, such as education and health, and to clean drinking water remains limited. The recent improvement on the macroeconomic front suggests that most, though not all, economies of the subregion have taken an important step in the right direction in improving the environment for investment decisions and hence for stronger long-term growth. At the same time, however, as GDP growth rates trend upward in the years ahead, the Governments of the subregion need to ensure that there is no slippage in the momentum. The emphasis on structural reform and improved governance, which has already provided a significant uplift to economic performance, must be maintained. In addition, Governments must ensure that the higher growth translates into more resources for the provision of social services and for infrastructure investments, two long-neglected areas of public policy over the years.

16. Despite the impact of SARS, collective GDP growth in South-East Asia in 2003 exceeded the pace achieved in 2002. Indonesia, Malaysia, Thailand and Viet Nam maintained their 2002 pace of rebound following the 2001 slowdown, while Cambodia, the Lao People's Democratic Republic, Myanmar, the Philippines and Singapore experienced reductions in their growth rates. The worst affected country was Singapore, where growth fell below 1 per cent in 2003. With the exception of the Lao People's Democratic Republic and Myanmar, where inflationary pressures remained high, the subdued pace of price increases slowed further in these economies. In virtually the entire subregion, GDP growth was stimulated by intraregional trade and domestic demand, both investment and consumption. The service sector was hit by SARS, but the adverse effects were confined to the second quarter of 2003 and were reversed in the second half of the year. Prospects for 2004 are positive, with GDP growth expected to pick up further momentum in all countries of the subregion. Inflationary pressures, however, are likely to increase modestly as higher raw material and commodity prices enter the production chain.

17. South-East Asian countries have been some of the best-performing economies in the ESCAP region for many years and have made good progress in reducing poverty in the process. The 1997 crisis and the 2001 downturn not only reduced growth and worsened the macroeconomic situation, but also undid much of the impressive progress made in poverty reduction in the 1980s and early 1990s. The policy issues facing the subregion consequently consist of regaining the pre-crisis momentum of growth and making up lost ground in the area of poverty reduction. However, this will involve the resolution of significant structural problems that came to light following the 1997 crisis and where much still remains to be done, notwithstanding considerable progress over the last six years. First and foremost is the need to speed up reform of the corporate and financial sectors and to deal conclusively with the issues of lingering corporate balance sheet weakness and impaired assets in the financial sector. Without progress in this area, a major upturn in corporate investment levels and technological upgrading is unlikely to take place on a durable basis.

18. The second major and interconnected issue is that of public finance. Governments have run up public debt to a high level in refinancing the financial sector and supporting the momentum of growth. There now needs to be a time-bound programme of fiscal consolidation together with a rebalancing of direct and indirect taxes and of expenditures to promote equity and enhance the provision of public and merit goods. Third, in a rapidly changing regional environment, and especially in view of the challenge posed by China's rapid growth, the subregion needs to direct resources towards enhancing competitiveness through skills upgrading and the development of more domestic technology.

19. In the developed countries of the region, 2003 saw a strong revival of growth in Japan, the world's second-largest economy, that for the first time in a decade bears the promise of durability. Australia and New Zealand continue to show dynamism so that there is a basis for all three economies to achieve output growth at, or near to, their long-term potential for a number of years. As Japan's economy is a major source of demand for the region's exports and a major provider of foreign direct investment for the region, these developments augur well for the future.

20. The key policy objective in 2004 for this group of countries is to sustain growth. In Japan, this requires decisive action on the domestic policy front to resolve long-standing problems in the banking sector, in the massive public debt and in the chronic deflationary pressures, which prevent a durable recovery of consumption expenditures in the economy. In Australia and New Zealand, the problems have to do with the maintenance of prudent macroeconomic aggregates in the near term, namely, containing the current account deficit, so that the pace of growth does not slacken in the coming years.

II. Policy issues and challenges

21. Even with the relatively buoyant growth that the region is currently enjoying, new policy issues and challenges are sure to arise. Some will emanate from adverse changes in the global environment, where national policies can only play an attenuating role. Others will arise that are more domestic in both origin and import; here, national policies can be more normative and directly address the issues that have arisen.

22. Some of the potential and problematic policy issues facing the region, such as the unwinding of global imbalances and the weakening of the dollar, are primarily international in character, but individual economies should nonetheless take appropriate action to shield themselves from their deleterious effects. Acting together in cooperation will be more effective than acting alone. Other potential and problematic policy issues, such as the appreciation of regional exchange rates, will require flexibility of response and alertness buttressed by stronger regional cooperation so that, should difficulties arise, corrective action can be taken in time.

23. Another area requiring policy attention is the possible emergence of asset bubbles in stock markets and in real estate and whether pre-emptive action is the right course to adopt given the level of uncertainty involved in how bubbles come about in the first place and the efficacy of traditional policy instruments in dealing with them, such as interest rate changes. In this context, the accumulation of large foreign exchange reserves, apart from raising the question of opportunity costs, given the low returns available on them, has also constrained somewhat the freedom of the authorities in the conduct of monetary policy by putting upward pressure on exchange rates. Yet others are regional issues, such as the incidence of avian influenza, where action has to be national, but without strong subregional and regional cooperation in containing the spread of the disease such action might be of little use. Finally, all Governments need to place short-term issues within their longer-term commitments, such as those made in accepting the Millennium Development Goals.

24. In the following paragraphs, the principal policy issues facing the region are discussed against this background. These issues have been discussed in previous issues of the *Survey*, but the passage of time often provides fresh insights and a better understanding of the underlying policy trade-offs.

25. The need for fiscal consolidation is becoming paramount. Last year it was stressed that Governments in the region should announce credible targets and supporting policies to stabilize public debt vis-à-vis GDP at a sustainable level. There is a need now perhaps for Governments to adopt more formally debt-to-GDP ratios and annual budgetary deficits as the European Union has done in its Stability and Growth Pact. If implemented with flexibility rather than mechanically, such targets could introduce a useful element of predictability in their public finances, thereby providing a more secure and informed basis for investment decisions in the economies concerned.

26. The consolidation of public debt should ideally be approached within a long-term programme of fiscal reform. All national tax systems in the region need to be defined by the aim to make them more equitable and efficient. One problematic element in the administration of national tax systems is the discretionary powers given to tax officials. These tend to dilute accountability, open up opportunities for corrupt practices and lower efficiency. There are no easy solutions to these problems, especially if they have existed for a long time. Nevertheless, the ongoing improvement of equity and efficiency in the area of public finance should be a long-term, focal objective. Corruption is a serious barrier to effective resource mobilization and allocation, and diverts resources away from activities that are vital for sustainable development. Even small incremental steps to reduce corruption will have a major cumulative impact on public resource generation and allocation. One

obvious route to greater accountability is transparency in the award of major public sector contracts.

27. Corporate and financial sector reform has made significant progress in the region as a whole. However, there is still a case for speeding up the pace of reform in most economies of the region, in particular in those countries that appear to be lagging in the implementation process. In this regard, the reform programme could perhaps be linked to initiatives for the development of financial markets in the region. As local bond markets grow in individual countries and new sources of finance for small and medium-size enterprises, such as venture capital, become increasingly available, it may be worthwhile simultaneously to facilitate regional or subregional linkages between these national markets. The development of regional or subregional markets will foster a broader investor base and reduce risk and uncertainty. Countries in the region should identify the impediments to the development of regional markets and seek to remove them. Information and communication technology offers a means of integrating national markets that was not available before.

28. The key to steady development in the medium term is maintaining and enhancing competitiveness, a process requiring a stable macroeconomic environment and a continuing programme of investment in infrastructure and in public goods. Investment in human resources development is a critically important element in this regard and, in this connection, the main challenges are to improve the quality of education at the primary and secondary levels, reduce dropout rates and enhance the performance of underachievers. Many countries in the region are not doing enough in this area and clearly risk falling behind in competitiveness. One of the Millennium Development Goals calls for the achievement of universal primary education by 2015. Merely fulfilling this quantitative target will not be enough; Governments should lay equal stress on the quality of primary education so that the number of children going on to secondary education goes up and all school-leavers acquire skills that will both enhance national competitiveness and provide them with good employment opportunities.

29. Small and medium-size enterprises in most of the region's economies are a major source of employment and output. However, financial market infrastructure is poorly developed to assist such enterprises in growing to an efficient size. The persistence of capital market imperfections makes it more difficult for small firms to access financing in order to upgrade or expand. There is also resistance on the part of owners to provide reliable balance sheet information in order to gain improved access to finance. Many small firms thus find it difficult to reach a minimum efficient size and are prone to financial difficulties, causing in consequence wasted or misallocated capital. Governments should reinvigorate existing programmes of training, technology transfer, information dissemination and the formation and deepening of clusters and networks to improve the performance of small and medium-size enterprises.

30. Governance remains an ongoing policy challenge virtually throughout the region. Despite good progress in establishing sound frameworks for improved private and public sector governance over the last decade or so, the quality of implementation remains uneven. Lack of access, or differential access, to administrative or legal redress when citizens are confronted by problems or are involved in contractual disputes lowers the overall efficiency of investment, makes

investors risk-averse and almost certainly reduces total factor productivity. Governments must take due cognizance of and correct the most obvious shortcomings, such as an unresponsive State bureaucracy and interminable delays in the legal process. Having the right laws is not enough; they must be seen to be effective in practice. Corporate malfeasance and corruption by public officials need to be tackled vigorously across the region.

III. Poverty reduction strategies: tackling the multidimensional nature of poverty

31. Poverty is a complex phenomenon, with its dimensions reaching much beyond income. The *Survey* examines trends in selected dimensions of poverty to ascertain the nature and extent of poverty in countries of the region and critically reviews national poverty reduction strategies and programmes, including those dealt with in Poverty Reduction Strategy Papers (PRSPs), to bring out commonalities, share experiences and draw lessons for designing more effective policies and programmes.

Dimensions and magnitudes of poverty

32. Poverty, being a multidimensional concept, is not easy to define. The *Survey* highlights four approaches to defining poverty: the monetary approach, the capabilities approach, the social exclusion approach and the participatory approach. The monetary approach defines a poverty line in monetary income sufficient to attain a minimal standard of living, while the capabilities approach focuses on the ability to lead a long life, function without chronic morbidity, be capable of reading, writing and performing numerical tasks and be able to move from place to place.

33. The social exclusion approach emphasizes relations among individuals. Social exclusion occurs when individuals or groups are unable to participate fully in the society in which they live. The participatory approach takes into account the views of poor people themselves. The people themselves decide what it means to be poor and that determines the magnitude of poverty. In cases where all the approaches identify broadly the same people as poor, any single approach can be used for measuring poverty. However, the empirical evidence shows that poverty rates in countries differ significantly according to the approach adopted. As a result, policy options can differ depending on the approach selected.

Trends in income poverty

34. Income poverty is the most serious problem facing many developing countries in the region. Despite the incidence of poverty in the region coming down from 37 per cent in 1990 to 25 per cent in 1999, based on the dollar a day poverty line, more than two thirds of the world's poor live in Asia and the Pacific.

35. The regional data mask the diverse performance of the countries. On the basis of the one dollar a day poverty line, poverty has been virtually eliminated in some countries, while many others continue to grapple with it (see table 2). Extra effort at both the national and regional levels would be necessary to enable those countries to make a dent in poverty reduction and achieve the Millennium Development Goals.

Table 2
Population below the one dollar poverty line in selected countries, 1990-2002
(Percentage)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Bangladesh	..	..	35.9	..	..	..	29.1	..	..	..	36.0	..	..
Cambodia	48.3	..	..	..	..	..	36.7	38.4	37.7	41.7	44.6	45.0	44.2
China	31.5	..	..	29.0	..	..	16.4	..	16.1	17.8	15.4	14.3	12.7
India	46.6	..	51.1	..	45.1	47.1	46.2	44.2	..	34.7	..	..	..
Indonesia	20.6	..	..	14.8	..	..	7.8	..	..	12.0	9.9	9.2	7.2
Kazakhstan	..	..	..	1.1	..	..	1.5	..	..	..	..	..	..
Kyrgyzstan	..	..	..	23.0	..	..	..	1.6	..	..	2.0	..	..
Lao People's Democratic Republic	53.0	..	48.8	..	..	..	41.3	38.4	36.6	36.7	35.1	31.3	30.0
Malaysia	2.0	..	1.5	..	..	1.0	0.8	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5
Mongolia	..	..	..	..	..	13.9	..	..	..	..	..	..	..
Nepal	..	..	..	..	..	37.7	..	..	..	..	..	..	..
Pakistan	47.8	..	..	33.9	..	..	31.0	..	..	..	..	..	..
Papua New Guinea	35.4	..	..	..	..	..	24.6	25.6	27.8	30.7	35.3	38.2	42.8
Philippines	19.1	19.8	..	..	18.4	..	14.8	12.1	13.7	13.5	13.5	11.9	11.5
Republic of Korea	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5	<0.5
Russian Federation	..	..	..	6.2	..	..	7.2	..	7.1	..	6.1	..	..
Sri Lanka	3.8	..	..	..	..	6.6	..	..	..	..	..	..	..
Thailand	12.5	..	6.0	..	..	..	2.2	..	3.3	3.1	5.2	3.6	2.4
Turkmenistan	..	..	..	20.1	..	..	..	..	12.1	..	..	..	..
Viet Nam	50.8	..	..	39.9	..	..	23.6	..	16.4	16.9	15.2	14.6	13.6

Sources: World Bank, *East Asia Update: Regional Overview*, October 2003, www.worldbank.org.cn/English/ Content/ EAP10-03.pdf, 20 November 2003, and global poverty monitoring web site, www.worldbank.org/ research/povmonitor, 17 June 2003.

National strategies for poverty reduction

36. Despite robust growth in the region as a whole, poverty continues to be a persistent problem in many countries. The success of East Asian economies up until the 1990s and China's achievements in making major inroads in poverty reduction in the 1990s confirm how high levels of growth can induce broad-based development and reduce poverty within a relatively short period. Macroeconomic stability, openness to international trade, human resources development and the rule of law underpinned high economic growth in those economies. Meanwhile, the Asian economic crisis in 1997 highlighted the necessity for institution-building to consolidate the aforementioned gains and avoid the pitfalls of liberalization.

37. In a number of countries, even when the economies are growing there has not been a commensurate improvement in the quality of life of the poorer sections of society. Poverty continues to persist because of inequitable distribution of the benefits of growth. The traditional approaches to development through national

planning and structural adjustment have had little impact on poverty reduction in many developing countries, as the central theme of such policies was not poverty reduction but growth and stability. Country experiences suggest that, in addition to sustained growth, measures designed specifically to increase access to economic opportunities for the poor are necessary if the benefits of growth are to be distributed evenly and poverty is to be eliminated on a sustainable basis.

38. PRSPs, whose core objectives are broad-based growth and poverty reduction, are a direct response to these issues. The PRSP approach is based on five core principles: it is country-driven, results-oriented, comprehensive and partnership-oriented and takes a long-term perspective for poverty reduction.

39. The *Survey* examined the poverty reduction strategies of 21 countries, including six interim PRSPs and seven full PRSPs. The overwhelming majority of those papers identify the lack of access to assets and basic needs, such as education, health care and safe drinking water, as the most critical issues concerning poverty and development. Several other country-specific issues, such as gender inequality, internal crisis and natural disaster, have also been highlighted as causes of poverty.

40. National strategies recognize the importance of both high-quality growth and pro-poor policies in reducing poverty on a sustainable basis. Reflecting this, the policy approach under PRSPs focuses on a combination of macroeconomic policies and structural reforms, such as financial sector reforms, fiscal reforms, trade liberalization, reforms in the agricultural sector and labour market reforms aimed at growth and stability, as under previous Structural Adjustment Facility and Enhanced Structural Adjustment Facility-related programmes, together with pro-poor policies particularly aimed at capacity-building for the poor.

41. The PRSP approach reflects a significant deviation from the previous adjustment processes by focusing on institutional developments that would be required for the effective implementation of such policies and the development of infrastructure, both urban and rural, to enhance a country's capacity for socio-economic development.

42. The inclusion of pro-poor policies, in particular policies for building the capacity of the poor and targeted social safety nets for the vulnerable, indicates a major shift in development policy advocated by multilateral lending agencies. Building the capacity of the poor is a key component of any sustainable poverty reduction strategy, as it would allow mainstreaming of the poor into the development process. PRSPs identify three major components of capacity-building: (a) empowerment; (b) providing opportunities; and (c) enhancing security.

43. The majority of the PRSPs have focused on empowering women as a development strategy, particularly in reducing the broader aspects of poverty. The underlying reasoning is the fact that in most developing countries gender gaps are widespread and the cost of ignoring such disparities is very high and increasing gender equity can have a positive effect on productivity and the human capital of the next generation.

44. The provision of social safety nets to vulnerable groups is an essential part of poverty reduction strategies, although it is not a substitute for policies to deal with social exclusion or the building up of capabilities. Fallouts from market-based policies, inequality in the distribution of assets and lack of opportunities could drive certain sections of society into poverty. In addition, the *Survey* finds that people in

developing countries in the Asia-Pacific region are driven into poverty by three other specific factors: increasing prevalence of diseases, particularly HIV/AIDS; inability to adjust to market economic systems; and social division and internal conflicts.

45. Recognizing the environment-poverty nexus, several countries have attempted to strike a balance between the existing livelihood requirements of the people and sound environmental resource management that can ensure sustainability by integrating environmental conservation into their national poverty alleviation strategies.

Handling the multidimensional aspects of poverty in PRSPs

46. Since poverty is a complex and multidimensional phenomenon, dealing with it requires a holistic approach that addresses cross-cutting development issues along with growth. However, dealing with various dimensions of poverty may require that priorities be set owing to financial and other resource constraints.

47. PRSPs are new and involve a learning process for many; there is therefore much room for improvement in country approaches to addressing cross-cutting issues aimed at reducing poverty on a broader scale. As such, achieving the Millennium Development Goals would greatly depend on the successful implementation of poverty reduction strategies built on a broader development framework. This is particularly important as PRSPs are to be used as the primary tool for achieving the Goals.

48. Although it is claimed that PRSPs are country-owned, external development partners continue to have a significant influence in policy formulation, effectively nullifying the country ownership. The pressure from external development partners would bias country strategies towards the agenda of multilateral lending agencies. In many instances, both bureaucratic and political ownership are lacking, while consultations with civil society have been limited. PRSPs could be made nationally-owned and acceptable to the communities at large by broadening the consultative process to involve civil society effectively and reflect its voice in the policy agenda.

49. PRSPs, which are linked to external financing, tend to be biased towards macroeconomic stability and growth rather than pro-poor policy strategies. The impact of macroeconomic stabilization policies on growth and poverty reduction needs to be assessed properly to ensure that the policies adopted are the most effective ones for reducing poverty on a sustainable basis. As the overarching objective of PRSPs is poverty reduction, more emphasis needs to be given to policies aimed at poverty reduction, while paying attention to macroeconomic stabilization to ensure sustainability.

50. The *Survey* finds that the relationship between PRSPs and the Millennium Development Goals is weak, as only a few PRSPs have benefited from any kind of analysis of the Goals in the preparation of poverty reduction strategies. The poverty reduction strategies in PRSPs or national development plans usually focus on a medium-term span of 3 to 5 years, while the Millennium Development Goals are set for 2015, a long-term target. Although several low-income countries have spelled out their own long-term visions even beyond 2015 and in certain cases linked them to the Millennium Development Goals, the link between such long-term goals and policy actions taken at present is very weak, with no underlying resource

commitment or policy approach, often leading to a vacuum in between. The PRSP targets could be directly linked to the Millennium Development Goals through intermediary targets set in PRSPs.

51. Country strategies reflected the lack of a proper poverty assessment, while some others did not focus their policy strategies on addressing the priority issues. The lack of technical and financial capacity appears to have constrained countries in developing an effective and comprehensive poverty reduction strategy. Some poverty reduction strategies do not provide an in-depth analysis of the root causes of poverty. Several others do not focus their policy on critical areas. For example, landlessness, unemployment and the gender gap, which have been identified as major causes of poverty, among other things, have not received adequate focus in the policy agenda for poverty reduction in certain instances.

52. The lack of a proper assessment of poverty makes poverty reduction strategies ineffective and the socio-economic outcomes of policy actions could deviate heavily from the desired goals. The medium-term policy matrices under PRSPs usually contain a long list of policy actions to be undertaken by Governments, reflecting the ambitiousness of the exercise. However, the pacing and prioritization of policy strategies need to be strengthened to ensure that policy strategies are implemented effectively, taking account of financial resource constraints as well as limitations in absorptive capacity. Policy strategies under PRSPs could be made effective if burning issues are addressed immediately.

53. The medium-term macroeconomic projections in PRSPs are often incomplete, overly optimistic and inadequately substantiated, and the analysis of the underlying economic and structural policies required for achieving such targets are weak, making policy outcomes less appealing. The reason for having overly optimistic macroeconomic projections, in particular the economic growth projections, could be due to their political sensitivity. Realistic targets are needed to keep the policy agenda on track and ensure that the ultimate objectives are met.

54. In several countries, little effort has been made to harmonize poverty reduction strategies and national plans owing to the lack of coordination between different branches of Government and the lack of clarity in their roles, the preparation of PRSPs and national development plans by separate agencies without close coordination and the lack of political acceptance. Such disparities could also emerge when multilateral lending agencies influence the PRSP preparatory process without taking account of national priorities and socio-economic conditions. This could lead to divergent policies and strategic directions. Harmonization of PRSPs and national development plans is essential to ensure that policy implementation by various agencies is consistent with country strategies for poverty reduction.

55. One of the major weaknesses of PRSPs is the lack of evaluation of downside risks of external and internal shocks, such as the deterioration of the terms of trade, recessionary conditions in industrial countries and the phasing out of the Multi-Fibre Arrangement for achieving the targets set for each year. Alternative contingency policy scenarios reconciling macroeconomic projections with these concerns and the trade-offs underpinning these choices are necessary if Governments are to minimize the deviation between actual performance and the original targets.

56. In many instances, macroeconomic frameworks emerging from PRSPs and those used for national budgeting processes are not closely linked, even when the

countries concerned are receiving programme support from multilateral lending agencies, such as the International Monetary Fund and the World Bank. In some PRSPs the medium-term expenditure framework is not well linked to the PRSP or the budget. Except for a few, Parliaments in the respective countries do not appear to have played a significant role in the PRSP process. This disconnection between policy frameworks under PRSPs and national development plans and the national budgets could nullify efforts to meet the Millennium Development Goals, as policy actions could deviate from the proposed policy agenda. Policy strategies alone are not sufficient to achieve goals; they must be followed by actions. Integrating the PRSP as an important input to government decision-making and budgetary processes is vital for the effective implementation of policies aimed at broad-based poverty reduction, as it enables policy design and costing of policy strategies to be matched with government priorities.

57. Effective monitoring and evaluation of the progress of poverty reduction strategies is essential for ensuring that the development targets are met. Such mechanisms also facilitate the identification and rectification of major institutional and resource constraints. The PRSP process being new, monitoring and evaluation would necessarily be an evolving process. Although some countries have proposed establishing separate units or teams for monitoring and evaluation, proper monitoring systems have yet to be developed.

58. Capacity constraints would constitute a major problem in effective monitoring and evaluation of poverty reduction strategies in many PRSP countries. This is one area where donor support could make a difference in scaling up capacity-building in monitoring and evaluation at the country level.

59. The international community, as a major stakeholder in global efforts to reduce poverty, can play a critical role in facilitating country efforts. The international community's direct involvement in the PRSP process would, in addition to providing financial and technical support, help to ensure Governments' commitments to undertake policy strategies needed to reduce poverty on a sustainable basis.

60. Addressing broad-based poverty issues at the global level would benefit not only low-income countries but also industrialized countries directly and indirectly, as emphasized in various global declarations, such as the Monterrey Consensus and the Johannesburg Plan of Implementation. While poverty reduction in low-income countries could create a larger market for industrial country goods and services, provide a source of inputs for their products, including knowledge and skills and expand opportunities for advanced country investments, it also addresses emerging social issues, such as global terrorism and the spread of diseases, which would benefit all. As such, the industrial countries and multilateral lending agencies could complement efforts by low-income countries to reduce poverty, in particular by:

(a) Providing technical assistance in capacity-building for the design of poverty reduction strategies under the PRSP process and for monitoring;

(b) Providing support for countries to undertake poverty and social impact analysis;

(c) Opening industrial country markets to developing country exports and phasing out trade-distorting subsidies;

(d) Helping to bridge the financial gap to meet the resource requirements for undertaking poverty-related development policies.

61. Such initiatives would facilitate the achievement of the goals of eradicating poverty and sustainable development as expressed in the Monterrey Consensus and also in developing a global partnership for development, as set out in Millennium Development Goal 8.

62. The fact that PRSPs are the primary strategic and implementation vehicles to achieve the Millennium Development Goals would essentially require the involvement of the United Nations in the PRSP process. This is particularly important owing to the multidimensional nature of poverty, in which the United Nations system has a niche, particularly in those areas which are not usually taken care of by stabilization policies alone. Fostering national ownership, capacity-building for the preparation, monitoring and evaluation of PRSPs, implementation of pro-poor policies and donor coordination (including the private sector) to fill the financing gap are some of the areas where the United Nations can be directly involved to make PRSPs more Millennium Development Goals-friendly and achieve the poverty reduction targets set for 2015.

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Summary of the economic survey of Latin America and the Caribbean, 2003

Summary

The economies of Latin America and the Caribbean as a whole grew by 1.7 per cent in 2003. This contrasts favourably with the 0.6 per cent reduction in gross domestic product (GDP) registered in 2002. The recovery was not strong enough to make up for the stagnation of recent years, however, and per capita GDP is still 1.2 per cent lower than in 1997. Gross capital formation showed practically no growth in the year and its current level is 12.5 per cent lower than five years ago. The upturn in economic activity generated a slight increase in the employment rate. Unemployment remained high, however, at 10.7 per cent and poverty spread to encompass almost 44 per cent of the population of the region. The more buoyant economic performance of Latin America and the Caribbean was associated with the international economic situation, which brightened with the recovery in the United States and Japan, and the growth of China.

The prices of commodities exported by the region increased by 15.4 per cent, while the variation in the total export price index, which includes manufactures, is lower (2.8 per cent). Despite a 1.5 per cent rise in import prices, this reactivation was sufficient to halt the 3.3 per cent deterioration in the terms of trade experienced between 1998 and 2002. The combination of volumes and prices has made exports the most dynamic factor of demand. A record trade surplus (US$ 41.8 billion) was recorded in 2003. The buoyancy of exports was fairly widespread — on the order of 5.9 per cent for Central America and the Caribbean, 7.8 per cent for the Andean Community and Chile and 18.9 per cent for the Common Market of the South (MERCOSUR). On the other hand, growth in Mexico's non-oil exports was flat (0.6 per cent), while exports from the region as a whole grew by 8.3 per cent. The trade surplus contributed to an almost unprecedented result in the region's current account: a US$ 5.6 billion surplus.

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Capital flows did not behave negatively, as they had in 2002. Autonomous capital movements were practically neutral with US$ 4.4 billion net in inflows comparing favourably with outflows of US$ 14.4 billion recorded last year. In 2003, the countries of the region were able to access funds at an average cost of 9.6 per cent, which meant 300 basis points less than 12 months earlier. Nevertheless, foreign investment continued to decline. Latin America and the Caribbean received nearly US$ 18.8 billion in compensatory funds, with a third of that sum coming from the International Monetary Fund.

This international environment provided a more favourable framework for the design of national economic policies. Fiscal and monetary instruments failed once again to produce the hoped-for counter-cyclical effects, however. The region's fiscal policy has been directed towards increasing the primary surpluses of Governments but economic growth has been slow. The region's primary balance rose by almost one percentage point, from a deficit of 0.3 per cent of GDP to a surplus of 0.6 per cent.

In terms of the direction of monetary policy, the central banks sought to control inflationary pressures. To achieve this, they initially raised rates and restricted liquidity. Once inflation started to subside, they induced a decline in interest rates, taking a more active stance in an effort to reverse the cycle.

Most countries have established and consolidated more flexible exchange-rate regimes and have been phasing out restrictions on foreign-exchange operations. By the end of the year, the average exchange rate index for the region showed a slight depreciation (1.9 per cent) compared with the end of 2002.

The design and application of various fiscal and monetary instruments resulted, among other things, in a decline in inflation. In 2003, prices rose by 8.5 per cent, four percentage points less than last year.

Bearing in mind the external situation and domestic economic trends, the prospects for 2004 are for a continuation of the upswing that began this year. Economic activity is expected to climb to an average rate of 4 per cent for the region, which is well above the average for the last five years. The region is estimated to have achieved a year-on-year growth rate of around 3 per cent in the fourth quarter and its more robust performance in the second half of 2003 will pave the way for the expansion of its economy in 2004.

Regional panorama

1. The economy of Latin America and the Caribbean grew by 1.7 per cent in 2003. In contrast, the region's per capita gross domestic product (GDP) remained flat at 1.2 per cent below the 1997 level. The lowest point of the cycle came in the first quarter of 2002, after which the economy began to make a mild recovery. The regional economy is expected to grow by 4 per cent, leaving behind the lost six-year period that went before and gradually entering into an expansionary phase. For the first time since 1997, there is no Latin American economy for which negative growth is projected.

2. This brighter outlook is in part a reflection of the more favourable international environment. The reduction in sovereign risk ratings from their peak levels of September-October 2002, the improvement in raw material prices, the expansion of tourism and the beginnings of an upswing in non-oil exports to the United States of America are the main positive impulses coming from the international economy. The stronger domestic positions achieved by the countries of the region are also significant, however. After six years of turbulence, most of the countries are emerging with fiscal and monetary policies well in hand and with more competitive exchange rates; even the economies that were overtaken by severe crises have already started to pick up.

3. The six years of negative per capita growth caused social damage that will take time to reverse. There were 20 million more poor Latin Americans in 2003 than there were in 1997. Unemployment increased by two percentage points during this period to stand at 10.7 per cent.

4. It appears that the projected growth phase will be stronger in those countries that have managed to reconcile improved economic governance with better political governance and weaker in those where the domestic political situation exhibits greater vulnerability. On the external front, the recovery of the world economy suffers from disequilibria that will have to be addressed primarily by the more developed economies.

5. The economies of Latin America and the Caribbean, taken as a whole, grew by 1.7 per cent in 2003. This contrasts favourably with the 0.6 per cent reduction in GDP recorded for 2002. The recovery has not been strong enough to offset the economic stagnation experienced in the region in recent years, however: from 1998 to date, the region grew by a low 1.4 per cent per year and per capita GDP is still 1.2 per cent lower than in 1997. The reactivation of investment and saving will be of key importance in achieving higher growth rates. Gross fixed capital formation remained stagnant in 2003 and by the end of the year was 12.5 per cent lower than the rate recorded five years earlier. National saving, which financed all of the year's investment, was also insufficient. All in all, the countries in the region had a lower savings rate than other emerging economies in the world.

6. The positive economic outlook led to a slight increase in the employment rate. However, at 10.7 per cent, unemployment remained high and it is estimated that during the course of the year some 600,000 persons joined the ranks of the urban unemployed, raising their number to 18 million. Given this weak growth profile and the sluggish labour market, it is hardly surprising that poverty and indigence in the region both increased further in 2003. The existence of 227 million persons (44 per

cent of the population) living below the poverty line suggests the scope and complexity of the problem to be tackled.

7. The region's stronger performance has been linked to the situation in the international economy. The recovery in the United States, where the annual growth rate is expected to stand at 3.1 per cent, made it possible for the Latin American and Caribbean region to increase its exports to that market. Japan also introduced a new demand factor in the international arena, since, at 2.7 per cent, its growth for 2003 is a vast improvement over the 2002 figure (-0.4 per cent) and the years of lethargy that preceded it. The Asian economies, led by China and its rapid expansion (9.1 per cent), boosted purchases and prices of various commodities exported by the Latin American and Caribbean region, such as copper, tin, iron and soybeans. The recovery and normalization of intraregional trade flows have also helped to fuel greater economic activity.

8. The combined effect of these factors was a 15.4 per cent increase in the prices of commodities exported by Latin America and the Caribbean. Leaving aside oil, whose price jumped by 21 per cent, the effect is still positive, although it is then reduced to 7.2 per cent. If the price index for total exports (including manufactures) is used, then the variation is lower (2.8 per cent). This upswing in export prices, although partially offset by a 1.5 per cent rise in import prices, was sufficient to halt the deterioration in the terms of trade seen between 1998 and 2002 (3.3 per cent). The improvement can be observed in oil-producing and non-oil-producing countries alike, with the exception of Central America. The combination of increased volumes and higher prices has made exports the most dynamic demand factor and has turned 2003 into a record year in terms of the region's trade surplus (US$ 41.8 billion). The buoyancy of exports was quite widespread as well, as growth rates for the year are on the order of 5.9 per cent for Central America and the Caribbean, 7.8 per cent for the Andean Community and Chile, 18.9 per cent for MERCOSUR and 8.3 per cent for the regional average. In contrast to this performance, Mexico's non-oil exports have been sluggish (0.6 per cent).

9. The hefty trade surplus contributed to a surplus of US$ 5.6 billion on the balance-of-payments current account. This is the first time a surplus has been posted in half a century. However, the negative level of external saving is a result that requires cautious consideration when interpreting the growth process. In emerging economies, it is important that external savings accompany an appropriate level of national saving in order to sustain capital formation. In 2003, however, the region has not only lacked a complementary flow of savings from the rest of the world but has also registered a decline in national saving in absolute values.

10. Apart from the growth impulses transmitted through the channel of trade, capital flows were also positive, in contrast to the situation in 2002. Autonomous capital movements, although modest — net inflows stood at just US$ 4.4 billion — compare favourably with the US$ 14.4 billion outflow registered the year before. Financial flows were negative, but direct investment more than offset that outflow. Foreign direct investment has been on the decline, and the level posted for 2003 (US$ 30.1 billion) is 23 per cent lower than the figure for 2002. This outcome points to a lower level of interest in local assets and suggests that the privatization process has run its course in many countries.

11. After a year of adverse markets for Latin American government debt in 2002, in 2003, the countries of the region were able to access funds at an average cost of

9.6 per cent, which is 300 basis points less than 12 months earlier. At the beginning of December 2003, the interest rates being paid by the region were similar to the rates paid during the first half of 1997, prior to the outbreak of the Asian crisis. Mexico's and Chile's risk premiums were at record lows, and Brazil's declined by 1,800 basis points between the last quarter of 2002 and December 2003. In addition, the Latin American and Caribbean region received compensatory funds amounting to almost US$ 18.8 billion. A third of this sum was provided by the International Monetary Fund (IMF), since 12 countries in the region are implementing agreements they signed with that organization. The balance of the funds corresponds to debt service arrears. In all, the countries have built up reserves of almost US$ 29.4 billion.

12. Despite the significant level of financing, the net transfer of resources continued to be negative (US$ 33.3 billion), equivalent to 7.9 per cent of exports. This fact reflects, among other elements, the increasingly negative results being recorded on the income account, specifically in terms of profit remittances, dividends and interest payments on the debt and on the foreign investments that have accumulated over the years. Another structural feature that has been taking shape in Latin America and the Caribbean is the inflow of remittances from nationals residing abroad. Current transfers, consisting mainly of remittances from family members abroad, amounted to US$ 33.5 billion in 2003 and are acquiring key importance in various countries of the region, in particular Mexico and various Central American economies.

13. The international situation described above has provided a more positive setting than in 2002 for the design of national economic policy. Once again, however, fiscal and monetary instruments have failed to generate the hoped-for countercyclical effects. In terms of public finances, the countries' high levels of indebtedness, which in various cases are above 50 per cent of GDP, acted as a major constraint and forced fiscal policy to move in the same direction as the business cycle. The effort to strengthen long-term fiscal solvency has dominated the design of income and expenditure policy, and fiscal policy in the region has thus been oriented towards increasing the primary government surplus, despite the fact that economic growth rates have been low. The primary balance of the region improved by almost one percentage point, moving from a deficit of 0.3 per cent of GDP to a surplus of 0.6 per cent. In view of this situation, the countries took steps to bring about an adjustment in expenditure, in addition to introducing other more intensive measures. More specifically, many Governments embarked upon social security reforms (especially in the public sector), new decentralization schemes, fiscal rules based on macroeconomic considerations and tax reforms. As the Economic Commission for Latin America and the Caribbean (ECLAC) has indicated on numerous occasions, macroeconomic management calls for efficient tools for moderating the cycle. The countries will not recover the ability to make use of fiscal instruments overnight, however, as a number of structural issues that strongly influence solvency must first be resolved. Hence the importance of the public-sector reform agenda being pursued by the countries.

14. As for the direction of monetary policy, the countries' central banks have focused on controlling inflationary pressures. Various countries have set inflation targets and are using interest rates as a tool for meeting those target levels. In others, the authorities have chosen to use monetary aggregates to provide them with benchmarks for this purpose. Whatever instruments are chosen, the prevailing goal has been to reduce inflation rates, which had climbed to double-digit levels in 2002.

This is particularly evident in countries such as Brazil, Colombia and Mexico, whose inflation indexes for the early months of the year were endangering their chances of meeting their policy goals. In order to deal with this situation, the authorities initially raised rates and restricted liquidity. Once inflation subsided, they paved the way for a reduction in interest rates and adopted a more active stance in an effort to reverse the business cycle. This greater degree of freedom in monetary management was possible, among other reasons, because of the improved fiscal outturn. Argentina, Brazil and Mexico finished the year with real lending rates that are much lower than the rates charged on loans at the beginning of 2003.

15. Most of the countries consolidated their use of more flexible exchange-rate regimes and have been phasing out restrictions on foreign-exchange operations. In fact, in 2003, very few changes were made in the countries' exchange-rate regimes. The only exception was Venezuela, which adopted a fixed exchange rate in February together with strict controls on foreign-exchange operations. Despite this preference for a flexible exchange rate, currency values are closely monitored by the authorities in view of the influence they have on real and financial flows. In addition, various countries in the region have maintained a high degree of dollarization in their economies or have simply adopted the dollar as legal tender.

16. The real effective exchange rate is a key variable for commercial competitiveness. In December 2003, the region's average exchange-rate index showed a slight depreciation (1.9 per cent) in relation to the end of 2002. Currency movements have been very uneven over the past months, however. The currencies of various South American countries (Brazil, Argentina and Chile) have not only undergone significant appreciations in relation to the dollar but have also risen slightly in value (0.7 per cent) against the currencies of their trading partners. By contrast, the Central American and Mexican currencies depreciated by 2.3 per cent against the dollar and 6 per cent against the other currencies. From an overall and longer-term perspective, the main point to be noted is that the exchange rates that are relevant to trade in the region were, in December 2003, 18.1 per cent higher than their 1997-2001 average. Maintaining suitable exchange rates is an essential ingredient in expanding the export base while bringing in higher value-added and more technologically complex production activities.

17. The design and implementation of various fiscal and monetary instruments has helped, inter alia, to reduce inflation. In 2003, prices have increased by 8.5 per cent, four percentage points less than the previous year. The region has thus returned to single-digit levels of inflation, as was the case between 1998 and 2001. This return to low inflation rates takes on added importance in the light of the difficulties experienced in 2001 and 2002, including, in particular, substantial rises in nominal exchange rates. Accordingly, relative prices were altered without fuelling inflation, in clear contrast to the problems encountered by the region in this respect in the past. The management of economic policy and the absence of cost pressures have also contributed to these results.

18. In view of the external environment and economic trends on the domestic front, in 2004, the region should continue the expansion that began in 2003. An increase in economic activity is expected to bring the average rate for the region up to 4 per cent, which is far higher than the average for the past five years. Growth estimates for the fourth quarter of 2003 point to an acceleration of economic activity to a level 3 per cent above the rate for the same period in 2002. Consequently, in

2004, growth will be fuelled by the region's improved performance in the second half of 2003. An analysis of various external and internal factors suggests that these favourable economic trends will continue during 2004. First of all, the positive factors that brought about the recovery in 2003, particularly in the export sector, will continue to apply. The reactivation of the world economy ought to continue, bringing with it an upturn in prices and in international demand for commodities. In the light of the most recent data, the recovery in the United States is also expected to continue in 2004, thanks to unprecedented fiscal and monetary incentives. Yet the situation is not free of risk. The serious external and fiscal disequilibria affecting the United States economy, combined with the reactivation under way, could make the dollar fall further and, in that event, interest rates would rise. Most analysts agree that these adjustments are necessary and ought to occur in late 2004 or in 2005.

19. There are also internal factors that contribute to this favourable outlook for 2004. Although each country has its own particular features and the factors discussed here have varying effects in each case, some considerations that are valid for the region as a whole can be advanced. First, domestic interest rates should remain low in 2004, especially with domestic prices continuing to trend downwards. Second, exchange rates in Latin American and Caribbean countries will remain high despite the cases of currency appreciation observed in the last few months of 2003. Third, if economic activity continues to pick up, fiscal policy would cease to be contractionary and could even become expansionary in some countries. Lastly, it should be pointed out that the region's performance will be influenced by the elections due to be held in various countries of the region during 2004.

Annex

Latin America and the Caribbean: total gross domestic product

(Annual growth rates)

Country	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
Argentina	5.9	5.8	-2.9	5.5	8.0	3.8	-3.4	-0.8	-4.4	-	8.6
Bolivia	4.3	4.8	4.7	4.5	4.9	5.0	0.3	2.3	1.6	2.7	2.6
Brazil	4.5	6.2	4.2	2.5	3.1	0.2	0.9	3.9	1.3	1.5	-0.2
Chile	11.1	5.0	9.0	6.9	6.7	3.3	-0.5	4.5	3.5	2.0	3.3
Colombia	4.2	6.0	4.9	1.9	3.3	0.8	-3.8	2.4	1.4	1.7	3.7
Costa Rica	7.1	4.6	3.9	0.8	5.4	8.3	8.0	1.8	1.2	2.8	5.5
Cuba	-	0.5	2.7	9.1	2.7	0.0	5.7	6.3	2.9	1.1	5.6
Ecuador	1.8	3.7	2.1	3.0	5.2	2.2	-5.7	0.9	5.5	3.8	3.0
El Salvador	6.4	6.0	6.2	1.8	4.2	3.8	3.4	2.0	1.7	2.1	2.0
Guatemala	4.0	4.1	5.0	3.0	4.4	5.1	3.9	3.4	2.6	2.2	0.6
Haiti	-8.0	-	9.5	5.6	3.2	2.9	2.9	2.0	-0.6	-0.2	0.6
Honduras	7.1	-1.9	3.7	3.7	4.9	3.3	-1.5	5.6	2.7	2.6	3.5
Mexico	1.8	4.4	-6.1	5.4	6.8	5.1	3.6	6.7	-0.3	0.7	1.3
Nicaragua	-0.4	3.4	6.0	6.6	4.0	3.1	6.9	4.4	3.1	0.7	2.3
Panama	5.3	3.1	1.9	2.7	4.7	4.6	3.5	2.6	0.4	0.8	4.0
Paraguay	4.0	3.0	4.5	1.1	2.4	-0.6	-0.1	-0.6	2.4	-2.5	2.1
Peru	4.8	12.7	8.6	2.5	6.9	-0.6	0.9	2.7	0.2	4.9	4.0
Dominican Republic	3.0	4.7	4.3	7.2	8.2	7.4	8.0	7.3	3.0	4.3	-0.4
Uruguay	3.6	7.1	-2.4	5.2	5.4	4.4	-3.5	-1.9	-3.6	-	2.3
Venezuela	0.1	-3.0	4.8	0.0	6.9	0.6	-5.5	3.8	3.5	-9.0	-9.2
Subtotal	**3.5**	**5.2**	**1.1**	**3.8**	**5.1**	**2.2**	**0.4**	**3.7**	**0.3**	**-0.6**	**1.7**
Antigua and Barbuda	5.0	6.2	-4.8	6.0	5.5	5.0	4.9	2.6	1.6	1.7	3.0
Barbados	1.1	4.4	1.9	2.5	2.6	4.0	3.0	3.1	-2.2	-0.4	2.5
Belize	4.3	1.5	3.7	1.3	4.4	2.0	6.0	10.5	4.7	3.7	4.0
Dominica[a]	1.9	1.9	1.2	2.9	2.2	3.1	1.3	1.3	-3.3	-5.8	0.4
Grenada[a]	-1.1	3.4	3.1	3.0	4.3	7.6	7.5	7.3	-3.8	-1.1	1.0
Guyana	11.4	9.4	3.8	7.4	6.8	-2.2	5.0	-2.3	2.3	1.5	1.0

Country	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
Jamaica	1.7	2.2	-0.2	-1.9	-0.9	0.7	1.0	1.7	0.9	0.9	1.0
Saint Kitts and Nevis[a]	5.2	5.5	3.2	5.8	7.2	1.1	3.5	5.6	2.0	0.9	1.9
Saint Vincent and the Grenadines[a]	2.0	-2.3	7.8	1.2	3.5	5.8	3.6	1.8	0.0	1.3	1.0
Saint Lucia[a]	1.6	1.6	2.1	0.8	-0.3	3.0	2.9	0.2	-4.1	0.2	2.0
Suriname[a]	-4.1	-0.1	0.0	5.3	3.3	2.9	-3.5	-1.2	1.3	1.2	3.5
Trinidad and Tobago	-1.2	4.2	4.2	4.4	4.0	5.3	7.8	9.2	4.3	3.0	5.5
Subtotal Caribbean[a,b]	**0.9**	**3.3**	**1.9**	**2.0**	**2.3**	**3.1**	**4.2**	**4.9**	**1.9**	**1.7**	**3.3**
Latin America[b]	**3.4**	**5.2**	**1.1**	**3.8**	**5.1**	**2.3**	**0.5**	**3.7**	**0.4**	**-0.6**	**1.7**

Source: ECLAC, on the basis of official figures converted into dollars in constant 1995 prices.

[a] The last column refers to the period 1990-1999.

[b] Refers only to those countries which submitted information.